
HERSHEY'S
MILK CHOCOLATE
Hershey Foods Corporation
1985 Annual Report

HERSHEY FOODS CORPORATION is a major producer of chocolate, confectionery and pasta products, and operates a chain of restaurants.

Hershey has chocolate and confectionery producing facilities in Hershey, Pa.; Oakdale, Calif.; and Smiths Falls, Ontario, Canada; and a confectionery producing facility in Stuarts Draft, Va. In addition, the chocolate and confectionery segment includes the H. B. Reese Candy Company, with its production facility in Hershey, Pa., and Y&S Candies, a manufacturer of licorice and licorice-type candies with plants in Lancaster, Pa.; Moline, Ill.; Farmington, N.M.; and Montreal, Quebec, Canada.

Friendly Ice Cream Corporation, headquartered in Wilbraham, Mass., operates over 750 restaurants located primarily in the Northeast and Midwest which serve high-quality, moderately-priced menu items and specialize in ice cream, sandwiches and informal meals. The Hershey Pasta Group has pasta manufacturing facilities in Lebanon, Pa.; Omaha, Neb.; Louisville, Ky.; Denver, Colo.; Kansas City, Kan.; and Fresno, Calif. Petybon Industrias Alimenticias Ltda., a wholly-owned Brazilian subsidiary, also produces pasta, as well as biscuits and margarine.

The Corporation's principal executive offices are in Hershey, Pa. The Corporation had 15,240 full-time employees and 17,529 stockholders on December 31, 1985.

EXECUTIVE OFFICES
100 Mansion Road East
Hershey, Pa. 17033

TRANSFER AGENT AND REGISTRAR
Manufacturers Hanover
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INDEPENDENT PUBLIC ACCOUNTANTS
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Financial Information
14 East Chocolate Avenue
Hershey, Pa. 17033-0814
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ABOUT OUR COVER

The production worker at HERSHEY'S GOLDEN ALMOND bar line is Jan Henning, a veteran of 25 years of service with Hershey Chocolate Company, the largest division of Hershey Foods Corporation. Jan is among the thousands of Hershey employees who reflect the skills, experience, loyalty and dedication which serve as essential elements of the Corporation's success. This 1985 Annual Report features, and is dedicated to, Hershey employees—our most valuable asset.

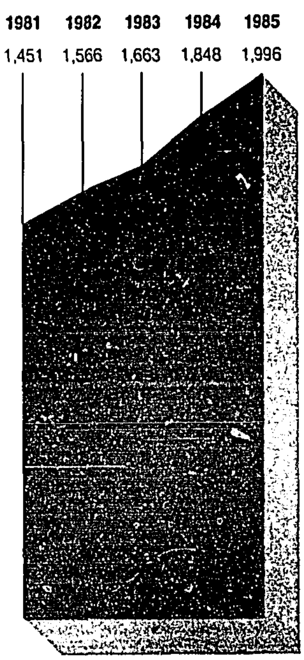
1985 Financial Highlights

(in thousands of dollars except shares and per share amounts)

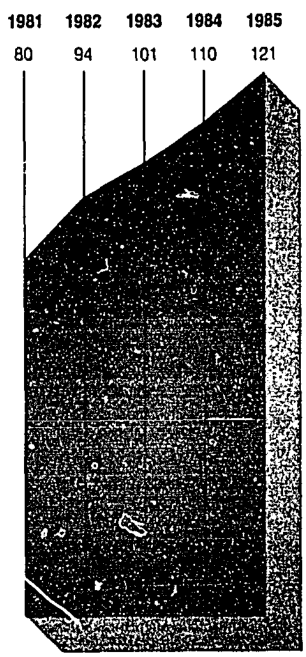
	1985	1984	Percent Increase
Net sales	**$1,996,154**	$1,848,492	8
Income from continuing operations	**120,649**	110,435	9
Net income	**112,227**	108,682	3
Income from continuing operations per share	**3.85**	3.52	9
Net income per share	**3.58**	3.47	3
Cash dividends paid per share of Common Stock	**1.425**	1.24	15
Cash dividends paid per share of Class B Common Stock	**1.285**	.315	N/A
Total cash dividends paid	**43,942**	38,680	14
Capital additions	**114,449**	87,049	31
Stockholders' equity at year-end	**727,899**	660,928	10
Price per share of Common Stock at year-end	**51.50**	38.63	33
Stockholders' equity per share at year-end	**23.23**	21.09	10
Outstanding shares at year-end	**31,337,112**	31,337,112	—

The amounts for 1984 and 1983 have been restated for discontinued operations. Shares of Class B Common Stock were issued in an exchange offer which was concluded on November 29, 1984. Total outstanding shares at December 31, 1985 of 31,337,112 consisted of 26,235,710 shares of Common Stock and 5,101,402 shares of Class B Common Stock. Income from continuing operations per share, net income per share and stockholders' equity per share are based on weighted average outstanding shares of 31,337,112.

Net Sales
(dollars in millions)



Income from Continuing Operations
(dollars in millions)



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Letter to Stockholders

Richard A. Zimmerman

We are pleased to report to our stockholders that 1985 was another record year for Hershey Foods Corporation and represented the eighth consecutive year in which your Corporation achieved improved sales and earnings.

Hershey's three major operating divisions posted record sales and operating income results during 1985. Hershey Chocolate Company maintained its position as a leading seller of chocolate and confectionery products in the United States. An excellent performance by the Division's established brands and continued contributions from new products resulted in a fine year for Hershey's largest division. An early 1986 price increase for the standard bar line has positioned the Division to maintain reasonable margins.

In its 50th year, Friendly Ice Cream Corporation's fine performance was achieved in a difficult environment for restaurant sales. Friendly's increase in sales was attributable to new restaurant openings and the acquisition of a regional restaurant chain, the introduction of new or enhanced product offerings, and menu price increases. This Division's new market expansion program was highlighted in 1985 by the opening of the first FRIENDLY restaurant in Orlando, Fla.

The Hershey Pasta Group experienced substantial growth in sales and operating income, primarily as a result of the acquisition of the business and assets of American Beauty. Acquired in late 1984, this regional pasta business enabled Hershey to attain the number one position in the U.S. branded pasta market. An important achievement during the year was the smooth integration of the American Beauty business into the Hershey Pasta Group's operations.

Yet another important step for Hershey in 1985 was the sale of Cory Food Services, Inc. and Cory Canada Inc. We decided to sell Cory based on the continued review of our strategic plan and evaluation of our ability to achieve satisfactory returns. We felt that Cory was not a suitable growth vehicle for Hershey in the future and that management time and effort, as well as corporate resources, could be better utilized if redirected.

As you read Hershey's financial statements, it should be kept in mind that 1984 and 1983 were restated to reflect the impact of Cory as discontinued operations to be consistent with the 1985 presentation of financial results. As a result of the loss on disposal of discontinued operations, the rate of growth for net income and earnings per share was less than in previous years. We firmly believe, however, that Hershey's performance, as indicated by sales and income from continuing operations, is a true measure of your Corporation's financial health and vitality.

Another measure of Hershey's financial strength is its dividend payment record. The quarterly dividend rate on the Common Stock was increased for the 11th consecutive year in December 1985. This increase was consistent with Hershey's current target of paying approximately one-third of earnings in dividends to its stockholders. Our dividend policy attempts to balance our stockholders' desire for an adequate return on their investment with the cash requirements of our businesses.

During 1985, Hershey devoted $114 million to capital additions in order to take advantage of the growth opportunities which our current operations present, as well as to maintain current facilities and improve productivity. Friendly Ice Cream Corporation has been identified as a significant growth vehicle for the Corporation and has been receiving an increasing proportion of the capital expenditures budget. During the year, Friendly opened 40 new restaurants and purchased the Franklin restaurant business, a Pennsylvania chain consisting of 12 family restaurants.

Our Chocolate and Confectionery segment, led by Hershey Chocolate Company, continues to be our largest and most significant operation and is assured of receiving all the resources it needs to operate in a highly competitive industry. In 1985, capital expenditures in this segment were devoted to the enhancement of production capacity for established, as well as new products.

In recent years, the Corporation has generated ample amounts of cash to fund its internal growth, as well as the acquisition of the American Beauty pasta and Franklin restaurant businesses. It is important to note that the Corporation's strong cash position, its considerable unused debt capacity and its ability to issue significant amounts of Common Stock also give Hershey the financial flexibility to achieve significant growth

Kenneth L. Wolfe

through acquisitions. This has been a stated objective in our strategic plan, and the Corporation is in the best position in its history to act upon this strategy.

We wish to remind our stockholders that Hershey's stated mission is to be a major diversified food company. Our proven strengths in the confectionery, packaged food and restaurant businesses give us confidence in our ability to add quality products and businesses to the Corporation.

During 1985, Hershey's management succession planning process continued to function smoothly, as John F. Cauley, President, Friendly Ice Cream Corporation, succeeded James D. Staggs as the head of Friendly's overall operations. Mr. Staggs retired at the end of 1985 after 36 years of service to Friendly, a career in which he helped Friendly expand from six restaurants to 752 at the end of 1985.

Also during the year, Thomas C. Fitzgerald, formerly Director, Commodities, was elected Treasurer of Hershey Foods Corporation. Charles A. Smylie, Vice President, Administration, and former President of Y&S Candies, Inc., retired in 1985 after 38 years of service to Hershey and Y&S.

Edward R. Book, Chairman and Chief Executive Officer of HERCO Inc. (Hershey Entertainment and Resort Company) was elected to the Board of Directors of Hershey Foods Corporation, effective April 29, 1985. We welcome the wealth of knowledge and experience he brings to our Board of Directors.

In addition to our strengths in manufacturing, marketing, distribution and restaurant services, we are convinced that our employees' skills, experience, loyalty and dedication to Hershey's efforts are keys to the future success of the Corporation. Hershey has always had a great deal of concern for the personal growth and development of its employees, feeling that they are the most important element in the successful implementation of the Corporation's business plan. For this reason, our employees are featured in the 1985 Annual Report.

We plan to continue to provide our people with a meaningful challenge and the resources to successfully meet that challenge. In that way, we will have furnished the necessary motivation to improve productivity, an area of endeavor which holds an important key to future profitable growth. Hershey has been successful in furnishing this type of atmosphere for its employees and has succeeded in adding significantly to the Corporation's earnings record through productivity improvement. In the future, we especially want to improve two-way communications with employees because people want to do well, and it is our responsibility to support them in their efforts.

One aspect of Hershey's heritage which makes our task in this regard somewhat easier is the Corporation's underlying value system, sometimes referred to as our corporate culture. This corporate culture is embodied in four key values: a caring attitude toward our employees, the maintenance of quality and value in our products and services, an adherence to high standards of conduct and ethics, and a strong emphasis on results coupled with a prudent approach to business.

As more of our employees become stockholders in the Corporation, they are in a better position to understand Hershey's business plan and how their own efforts contribute to its success. As stockholders, they also can share in the rewards of these efforts to an even greater extent as the investment community recognizes the Corporation's increasing value. We recognize employees as Hershey's most valuable asset, and we dedicate this 1985 Annual Report to our 15,240 full-time and over 22,000 part-time employees in all parts of the world.

Chairman of the Board and
Chief Executive Officer

KL Wolfe

President and
Chief Operating Officer

…Crabb, Machine Operator, …Department, Hershey … years

Chocolate and Confectionery

HERSHEY CHOCOLATE COMPANY

Hershey Chocolate Company's 1985 sales and operating income exceeded the record performance of the previous year. Sales growth was attributable primarily to increased unit volume in established confectionery products. Selected price increases were also implemented in 1984 and 1985, on both confectionery and grocery products.

These results were achieved in a year in which the Company was faced with increased competitive spending on advertising and promotions. The year saw unprecedented activity in the consolidation of competitors through food company mergers and the consolidation of customers through similar circumstances. Introduction of new products and increased marketing expenditures to support existing products by foreign manufacturers also made 1985 an especially active year in the food industry.

The operating income increase over 1984 resulted from a combination of higher sales and operating margins. The higher operating margins can be attributed to increased productivity and stable-to-lower costs for several major commodities, which more than offset increases in the cost of cocoa beans and other cost components.

Established confectionery brands accounted for the majority of the unit volume growth, led by a record sales year for REESE'S peanut butter cups, which gained in virtually all major pack types. The quality and packaging improvements implemented in late 1984 on HERSHEY'S milk chocolate bar and HERSHEY'S milk chocolate bar with almonds contributed to the success of these brands in 1985. These improvements, combined with increased advertising and promotional support, propelled the latter brands to significant increases over 1984.

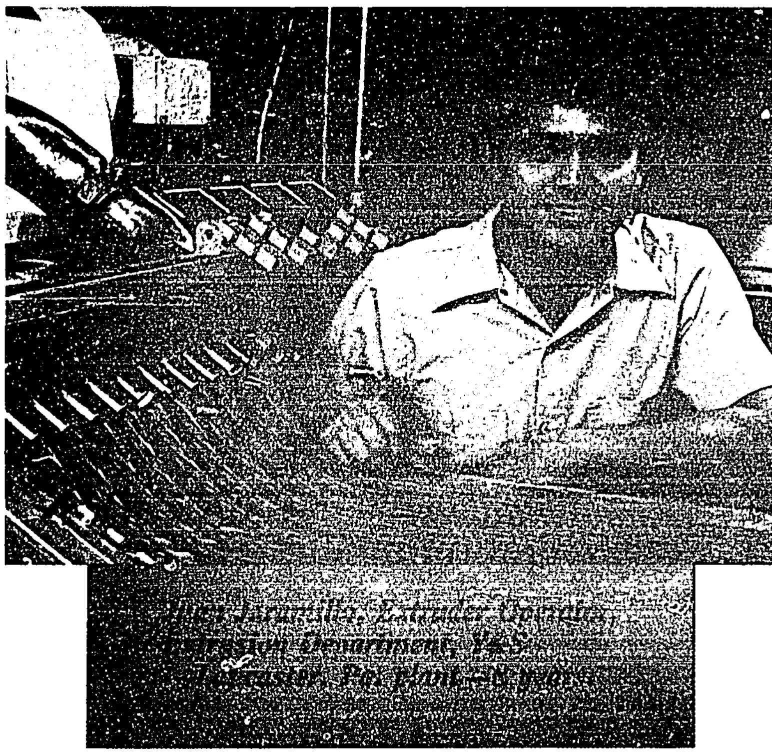
Spurred by a national brand emphasis program and the national introduction of a new 10-pack item, KIT KAT wafer bar registered a record performance. HERSHEY'S KISSES chocolates recorded another fine performance, benefiting from strong seasonal sales, which were also very strong for REESE'S peanut butter cups and ROLO caramels in milk chocolate. In addition, the HERSHEY'S KISSES brand was supported by a strong back-to-school program, a bonus package offering two free ounces, and the national rollout of a single-serving package.

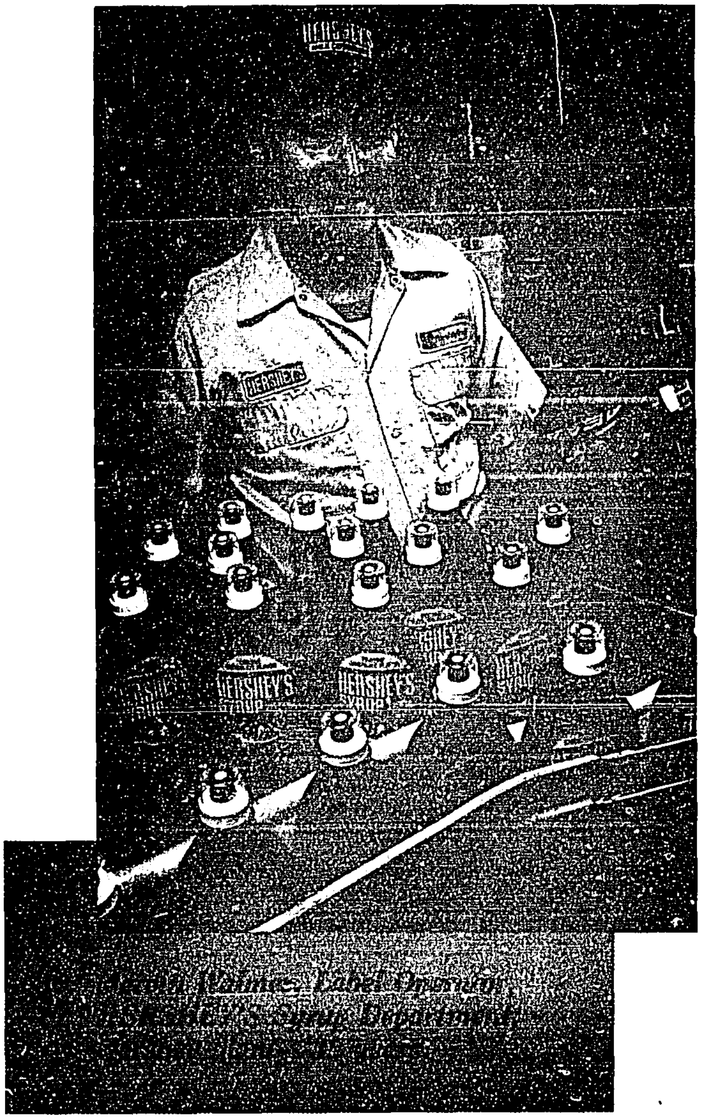
For the second consecutive year, Y&S licorice and licorice-type candy sales recorded double-digit sales growth, resulting from a combination of high-quality products, effective promotions, and a national advertising program. As a result of continued improvement in product quality and a pricing strategy that provided superior product value, HERSHEY'S chocolate chips improved its position in the baking chips category in 1985.

Several new products were under development in 1985, and one or more are expected to be introduced in 1986. In its second year of national distribution, SKOR toffee bar has doubled the size of the chocolate toffee market segment and leads the category.

NEW TRAIL granola snack bars, the Company's granola entry, continued to face intense competition. Capitalizing on a strong trend in the market, the Company introduced three chocolate covered granola items in December 1985. Trade reception has been very favorable, and it is anticipated that the new items, together with the Company's regular granola bars, will strengthen the brand. HERSHEY'S chocolate milk, licensed through dairies and distributed in all 50 states, has achieved a stable and profitable sales level.

The Special Markets Group successfully completed the national rollout of the single and one-pound box versions of GOLDEN ALMOND SOLITAIRES, whole almonds covered with HERSHEY'S milk chocolate. The





brand has been received enthusiastically by retailers and consumers, and initial sales have been excellent.

The Company's people and their talents play a major role in the success of its business. As a result, special attention is paid to employee training in order to maintain a high level of awareness of changing business methods and procedures, and, in 1985, over 38,000 employee hours were logged at in-house training programs intended to improve job skills. At the management level, newly-appointed managers participate in a series of workshops during the first year of their assignments. Experienced managers continue their business education in executive management programs at major colleges and universities throughout the United States.

Increased capital spending in 1985 was directed toward projects to increase the production capacity of both established and new products. In addition, other investments were made in general facility improvements and office equipment.

The Company is dedicated to providing the highest quality products and services to its customers. This includes working with customers to attain the lowest possible overall cost of distribution and supplying the proper mix of products and packs to respond to their changing needs. The concept of quality, low-cost production begins with manufacturing and continues through the distribution system into Hershey customers' outlets.

HERSHEY CANADA INC.

Hershey Canada Inc. achieved record sales and operating income in 1985, despite a decline in the value of the Canadian dollar in relation to the U.S. dollar. Sales growth was attributable to both increased volume and higher selling prices.

Although the economic climate in Canada was one of general growth in 1985, there was no growth in the major markets in which Hershey Canada competes. In spite of these circumstances, better than half of Hershey Canada's 1985 sales growth was generated by volume increases. Market share increases were achieved in 1985 in all major consumer product categories.

Within the important standard bar segment, established brands and new products contributed to volume growth. The consumer value of REESE'S peanut butter cups was substantially improved with a 35 percent weight increase. This was implemented by changing from a two-cup to a three-cup package in April, a move which stimulated strong growth in the brand.

Also, bar weight increases averaging 10 percent contributed to sales volume growth for the HERSHEY almond, SPECIAL CRISP and REESE'S PIECES candy lines. New product sales volume was contributed by the SKOR toffee bar, which has proven to be one of the most successful standard bars introduced in the Canadian market in recent years.

Y&S licorice and licorice-type candy brands also showed strong volume growth in 1985, maintaining the momentum which began in 1984 as the result of a licorice restaging campaign, which included increased weights, new package designs and aggressive promotional support. Though competing in declining markets,

Tony Bertoldi, Production [illegible] REESE'S Peanut Butter [illegible] Department, Hershey, PA [illegible]

Judy Risser (left), Manager, Product Development (Dairy)—[illegible] years; and Bo-Jule Horn, Senior Food Technologist—5 years, Corporate Technical Center.

BROWN COW liquid milk modifier and HERSHEY'S syrup also achieved volume increases as a result of effective and aggressive marketing programs.

The Special Markets Group, which includes export, food service and fund raising sales, also achieved excellent volume growth in 1985. The majority of this growth was contributed by sharply increased amounts of selected products supplied to Hershey's operations in the United States.

In April, a 10 percent price increase was implemented on the standard bar and licorice lines, resulting in an increase in the normal retail price from $.45 Cdn. to $.50 Cdn. in most outlets. This price action, in response to generally higher costs of doing business, was the first increase in standard bar prices since June 1983. In addition, price increases in the 5 percent to 6 percent range were implemented during the first half of 1985 on most other major confectionery and grocery lines.

Lawrence Watson, Paste Processing System Operator, Hershey plant— 24 years

An important and disconcerting event during the year was the Canadian government's decision to apply a 10 percent sales tax on all confectionery products effective July 1, 1985. This resulted in a 10 percent price increase at retail on all confectionery lines in addition to price increases already implemented by Hershey Canada and the industry. As a result of the additional increase, the normal retail price for a standard bar became $.55 Cdn. effective July 1, a 22 percent increase over the $.45 Cdn. price in effect prior to April.

Major commodity costs in 1985 were either stable or lower than in 1984. Further, productivity gains were achieved throughout the entire business. These improvements, plus the price increases implemented throughout the year, combined to offset higher costs of labor, packaging and marketing.

Without question, the efficient and productive work by Hershey Canada's employees is the single most important reason for its success. In 1985, Hershey Canada continued its commitment to maintain a pleasant work environment while challenging and motivating employees to develop to their highest potential.

HERSHEY INTERNATIONAL LTD.

In 1985, sales increased over the previous year and operating income was again positive for the chocolate and confectionery operations of Hershey International Ltd. This was gratifying in view of the negative impact of a strong U.S. dollar on export sales early in the year and the difficult economic conditions experienced in Mexico, one of Hershey International's largest foreign markets.

Export sales of Hershey's products improved in the Middle East and Latin America. The Division increased advertising and promotional support, expanded distribution, and introduced new products and packaging which were well received in those markets. In the Far East, export sales declined slightly because of a switch to locally-licensed manufacture of HERSHEY'S syrup in Japan, and an influx of low-priced confectionery imports from Europe.

A licensing agreement was reached in 1985 with Hai-Tai Confectionery Company in Korea, and locally produced HERSHEY'S milk chocolate, KRACKEL, and HERSHEY'S MINIATURES bars were introduced successfully in that country. Additionally, Hershey's Philippine affiliate, Philippine Cocoa Corporation, introduced HERSHEY'S BROWN COW liquid milk modifier and HERSHEY'S GOLDEN SELECTION milk chocolate bar line, both of which are manufactured locally. In Brazil, BROWN COW syrup, produced by Hershey's joint venture company, Lacta/Hershey, continued to expand in distribution.

Hershey's 50 percent-owned Mexican affiliate, Nacional de Dulces, S.A. de C.V., reported significantly improved results in comparison to the previous year. This higher level of performance was achieved despite the tragic earthquake and declining oil prices that now burden the economic climate. HERSHEY'S MINIATURES bars and HERSHEY'S KISSES chocolates, together with premium quality lollipops, were the primary contributors to sales increases.

AB Marabou, Hershey's 20 percent-owned affiliate in Sweden, reported increased sales. Profits were somewhat lower in 1985 than in 1984, because of higher costs for cocoa in Sweden.

Greta Ranode, Waitress,
Hershey, Pa.—5 years.

FRIENDLY ICE CREAM CORPORATION

Friendly Ice Cream Corporation celebrated its 50th anniversary during 1985. In the middle of the Depression, two young brothers, Curtis and Prestley Blake, borrowed $547 from their parents to open the first FRIENDLY outlet in a Springfield, Mass. storefront. Except for a temporary suspension of operations during World War II, Friendly grew and prospered for five decades. Friendly became a Hershey company in 1979, and, since that time, its sales and operating income have more than doubled as Friendly continues to adhere to its founders' basic policy: "We try to excel in three areas: quality service, quality people, and quality products—all at a fair price."

Sales and operating income for Friendly exceeded the prior year's record levels despite heightened competition and an overall lack of real sales growth in the restaurant industry. Industry sales were dampened by weaker customer traffic brought about by slower growth in consumer disposable income. Also, the restaurant business was adversely affected by prices of restaurant meals rising faster than grocery store prices and by competition for the consumer's discretionary dollar.

The increase in Friendly sales over 1984 is attributable to the opening of additional FRIENDLY restaurants and the acquisition of the Franklin restaurant business, the introduction of new or enhanced product offerings, and menu price increases. Over one-half of the sales increase came from menu price increases. The remaining sales gain was derived from newly-constructed and acquired restaurants, which offset a slight decline in customer traffic and sales on a comparable store basis.

Friendly's sales growth resulted in market share stability in the Friendly operating regions despite extensive competitive activity. Major chains continued to introduce new menu items, and several competitors expanded operating hours to include new day-part segments such as breakfast. While Friendly lost some ground in the breakfast day-part due to this increased competition, its share of the lunch and dinner markets exceeded expectations and countered the adverse industry trend in those parts of the restaurant day.

The Franklin restaurant business was acquired by Friendly on September 30, 1985. FRANKLIN'S is a chain of 12 full-service family restaurants in northeastern Pennsylvania. This acquisition is consistent with Friendly's strategic objective to acquire additional food service concepts which complement its existing business.

Friendly's overall cost of food and supplies remained stable throughout 1985, with many food items reflecting costs at or below prior year levels. A severe shortage of restaurant workers in some operating areas, which began in 1984, continued in 1985. As a result, employee turnover remained high and operating margins were hampered as the costs to attract, train and retain a competent restaurant labor force continued to increase.

The comparatively low rate of unemployment in many of Friendly's New England markets is the primary reason for the shortage of restaurant workers. In addition, a decreasing number of teenagers in the general population has contributed to the problem.

The measures implemented to alleviate this problem in 1985 included higher pay scales, increased recruiting activities and more time devoted to training new employees. During 1986, the industry-wide demand for restaurant workers is expected to result in continued pressure to advance pay scales and expand employee benefits. Friendly's recruiting efforts will continue at an accelerated pace during 1986.

During the year, 40 FRIENDLY restaurants were opened, of which 31 were freestanding and nine were located in shopping centers. Six of the freestanding units were conversions to FRIENDLY restaurants on locations acquired from other restaurant companies. Seven FRIENDLY restaurants were closed. At the end of 1985, a total of 752 restaurants were in operation, including FRANKLIN'S restaurants.

Friendly's new market expansion program was highlighted in 1985 by the opening of the first FRIENDLY restaurant in Orlando, Fla. After several months of operation there, sales have significantly exceeded expectations. Friendly anticipates opening additional units in this market throughout 1986 and beyond.

Polly Linson, Director, Marketing Planning & Analysis—6 years, and Scott Colwell, Manager, New Business Development—4 years, Friendly corporate headquarters, Wilbraham, Mass.

Several new Friendly menu introductions contributed strongly to the solid performance during the lunch and dinner day-parts. New sandwich and platter toppings, which were introduced in late 1984, succeeded in increasing consumer demand for beef product offerings during 1985. A chain-wide introduction of a new lunch and dinner menu was completed in June 1985. The menu includes a six-ounce, 100 percent sirloin steak burger which customers have found appealing both with and without the optional toppings. The total line of hamburger servings increased nearly 15 percent over 1984 levels.

The new menu also offers several additional sandwiches and salad-type items targeted at customers interested in lighter foods. Prime-time television advertising in major Friendly markets, in conjunction with product promotions, supported the new menu introduction from May through August. In total, the new menu resulted in an increase in the average customer check, as existing customers shifted to the new items.

In the area of ice cream products, the HAPPY ENDING dessert sundaes, which were introduced in 1984, continued to thrive. In the prepackaged line, the DUTCH FUDGE ROLL dessert was introduced in June as a year-round product at a price comparable to Friendly's Christmas season JUBILEE ROLL dessert. The all-occasion FRIENDLY ice cream cake introduced in 1984 also sold well. Three new ice cream pie flavors were introduced and offered on a rotating basis during 1985.

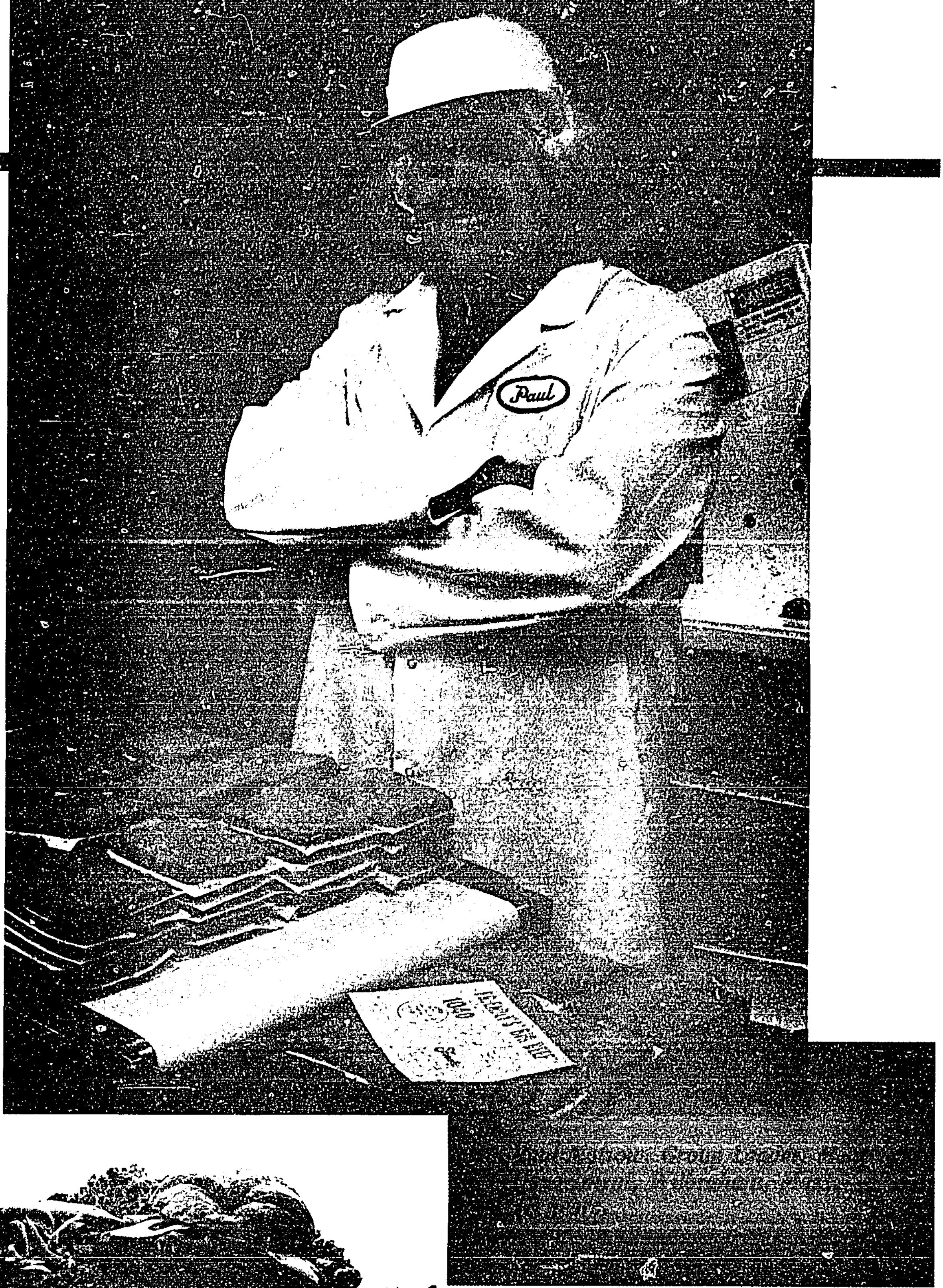
Having the right number of the right people has always been the key to Friendly's success. As competition for restaurant employees intensified throughout the food service industry during 1985, Friendly's employee training and development activities more than doubled. Programs focused on the selection, qualification and retention of restaurant employees.

"FASTrack to Excellence," a new crew training program which was introduced at 250 restaurants, significantly reduces the time required for new employees to learn the basic requirements of their jobs. The program develops customer satisfaction skills and features incentives rewarding progress. By the end of 1985, nearly 10,000 employees had participated in FASTrack.

Friendly's restaurant manager training program was refined to place increased emphasis on development of the interpersonal and first-line supervisory skills needed to manage others. Development programs for existing managers focus on more advanced recruitment, training and leadership skills.

An automated human resource information system was established at Friendly headquarters and provides a comprehensive data base on current employees, including their education, experience and career interests. This information enables recruiters to match the qualifications of employees to specifications for select position openings, enhancing Friendly's ability to promote from within.

Friendly again participated in the Federal government's Targeted Jobs Tax Credit Program in 1985. This program, which the government will phase out beginning in 1986, encouraged the hiring of people from groups identified as having high unemployment or special employment needs. It allowed Friendly to earn Federal income tax credits by providing such job opportunities.



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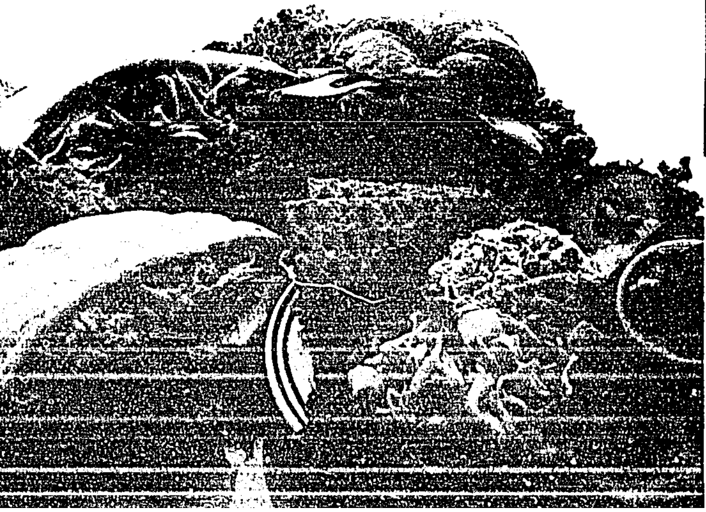
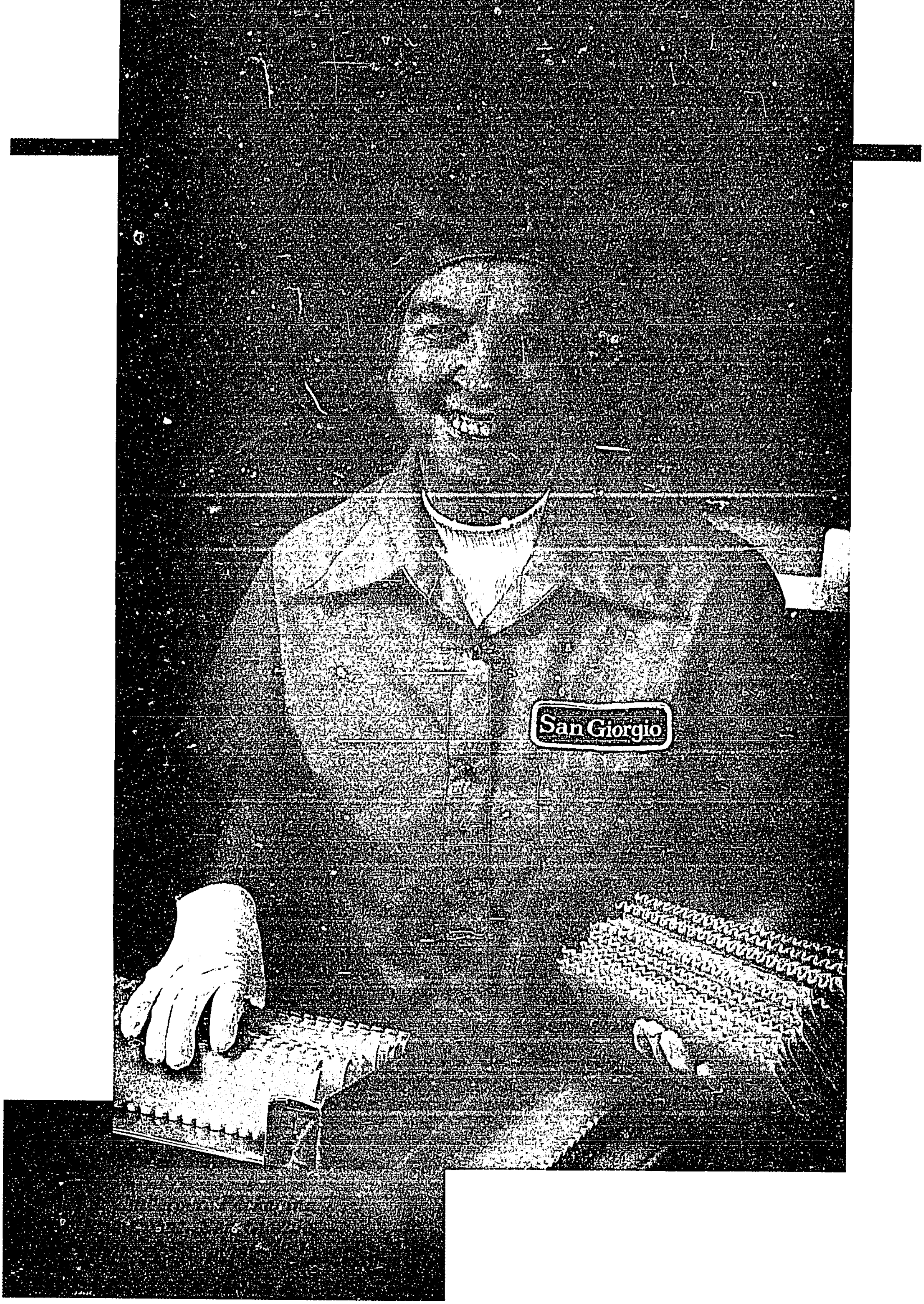



San Giorgio

Other Food Products

HERSHEY PASTA GROUP

During 1985, Hershey Pasta Group achieved record sales and operating income. Real sales growth outpaced the industry, while selling price increases were below industry levels. The sales increase resulted principally from volume gains, most of which were attributable to the acquisition of the AMERICAN BEAUTY brand in November 1984. However, volume gains also were experienced by the Group's other brands.

Operating margins were maintained at the record 1984 levels, as lower commodity prices and productivity gains were offset by increased costs due to upgrading the ingredient quality of the AMERICAN BEAUTY brand and by higher marketing expenditures in response to competitive pressures from domestic and foreign companies.

Hershey Pasta Group, which consists of six regional brands—AMERICAN BEAUTY, SAN GIORGIO, SKINNER, DELMONICO, P&R and LIGHT 'N FLUFFY, has maintained the market share leadership position in the $1.3 billion (at the wholesale level) U.S. pasta industry, despite continued consolidation of the industry. The size of the Group's pasta operation enables it to enjoy economies of scale in raw material procurement, manufacturing operations and distribution systems.

The Group's approach to the pasta business recognizes that consumers have strong brand preferences, which are regional in nature, and tend to be one-brand buyers. Marketing expenditures increased substantially as a program of advertising and consumer promotions for the AMERICAN BEAUTY brand, in combination with packaging revisions, was initiated.

A major accomplishment of the Hershey Pasta Group this year was the successful integration of the American Beauty business into the overall pasta operation. In keeping with Hershey's approach to acquisitions, key personnel essential to the continuity of an efficient operation were retained. The Group consolidated its selling operations, devised a cohesive marketing approach for all brands, and committed a significant percentage of its capital expenditures to the upgrading of plant and equipment at American Beauty's Denver, Colo.; Kansas City, Kan.; and Fresno, Calif., manufacturing facilities.

PETYBON INDUSTRIAS ALIMENTICIAS LTDA.

Petybon Industrias Alimenticias Ltda., Hershey's wholly-owned Brazilian subsidiary, increased its market share for pasta in the greater Sao Paulo area despite heavy promotional activities by key competitors. Nationally, market shares for biscuits and margarine products also increased over the levels achieved during 1984.

As a result of increased sales and productivity gains, Petybon's operating income improved in comparison with 1984. This is noteworthy in view of extremely high inflation levels and Brazilian government price controls. However, local borrowings required to finance working capital needs remained high during 1985. As a result, Petybon sustained a net loss for the year.

During the year, the Corporation invested additional capital in Petybon in order to reduce its debt and interest expense. This capital contribution was made in August 1985 and resulted in significantly less interest expense during the fourth quarter.

Subsidized imports have been a major industry issue during the past few years, and 1985 was no exception. For several years, pasta imports have enjoyed a distinct cost advantage over domestic pasta products. Subsidies by the European Economic Community enable Italian manufacturers to undersell U.S. brands in the U.S. market, in violation of international trade agreements.

Considerable efforts at negotiation failed to resolve the situation, and, on November 1, 1985, the U.S. imposed a tariff of 25 percent on imported pasta products containing eggs and 40 percent on products not containing eggs. Prior to that action, the European Economic Community had increased support levels dramatically. While the current trading situation represents an improvement for domestic manufacturers, the political nature of this issue gives rise to uncertainty as to its future direction.

Our Employees – Hershey's Most Valuable Asset

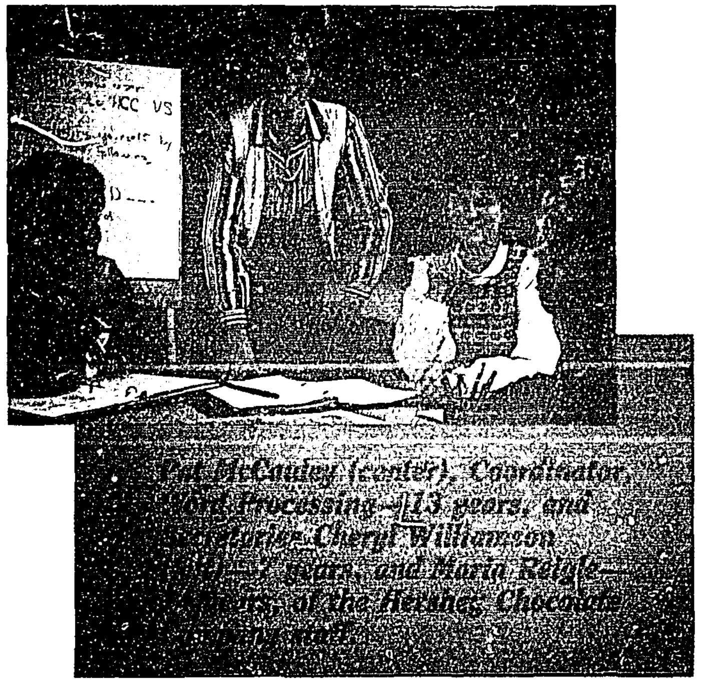
The concerned involvement of employees is essential to the successful implementation of Hershey's business plan. Hershey's commitment to future profitable growth is dependent on its ability to provide every employee with the opportunity to contribute to, and participate in, the Corporation's success.

A survey of Hershey employees in early 1985 gave fairly high marks to the Corporation's internal communications efforts. More importantly, it generated ideas for improvement. To set the tone for the desired communications improvement, Richard A. Zimmerman, Hershey's Chairman and Chief Executive Officer, held more than 40 group meetings over several months with representative cross-sections of employees from throughout the Corporation. The meetings not only offered employees an opportunity to meet the Chief Executive Officer, but communicated directly to them the *sense of direction* of Hershey Foods Corporation, as seen through the eyes of the Chief Executive Officer; the *corporate strategic plan,* with particular attention to the goals of the Corporation and the operating divisions; and *corporate culture and values*—how Hershey's heritage and values help shape the fabric of the Corporation.

A broad spectrum of programs are in place on the training and development front to help all employees improve their skills and realize their personal growth aspirations. In 1985, over 10,000 employees were involved in training activities at the management, administrative, production, sales, and restaurant operation levels. It is the Corporation's intention to give those employees interested in committing themselves to personal advancement ample opportunity to succeed.

Emphasis in the Corporation's management training programs has been two-fold: to provide specialized training in such functional areas as finance and marketing and to provide general management training. The Hershey Foods Management Program, an intensive general management program designed to develop the blending of skills needed to manage a total organization, as well as integrate Hershey's strategic thinking, was initiated in 1985.

Employee stock ownership can be an important element of corporate success. Recognizing that an economic stake heightens employee interest in an enterprise's activities, Hershey has taken steps over the last eight years to encourage employees to own a greater stake in the Corporation. In 1978, the first of the Corporation's employee savings and stock investment plans was inaugurated at most locations, reaching a participation rate of over 70 percent in its first year. With the recent addition of a pre-tax deferral option, and the extension of these plans to additional employees, participation has grown to over 81 percent of eligible employees. Within these plans, a portion of employee savings is matched with Hershey Common Stock purchased by the Corporation. Currently, over 8,000 participants hold approximately 395,000 shares in their plan accounts. In addition, an Employee Stock Ownership Plan enables eligible Hershey employees to accumulate additional shares of Hershey Common Stock, and slightly more than 91,000 shares were accumulated under the plan by the end of 1985.



[illegible] McCauley (center), Coordinator, Word Processing—13 years, and [illegible] Cheryl Williamson [illegible] years, and Maria Reigle— [illegible] of the Hershey Chocolate [illegible] staff.

While productivity improvement has long been an important activity in the operating divisions, only recently has a corporate organizational structure been established to assure cohesiveness and coordination of efforts. Today, a corporate-level Productivity Council exists with 11 senior representatives from all the operating divisions and the corporate staff. In addition, each operating division has individuals or groups responsible for setting the direction for productivity improvement efforts in its units. Various departments in the divisions and within the corporate staff have productivity coordinators responsible for supporting the efforts at the grass-roots level of the organization. As a result of these efforts, it is estimated that the Corporation will realize annual savings in excess of $26 million, $17 million of which relates to Hershey Chocolate Company.

HERSHEY STOCKHOLDERS

As of December 31, 1985, the Corporation had outstanding 26,235,710 shares of Common Stock and 5,101,402 shares of Class B Common Stock owned by 17,529 stockholders of record.

STOCK MARKET DATA

Hershey's Common Stock is listed and traded principally on the New York Stock Exchange under the ticker symbol "HSY." Class B Common Stock is not listed for trading. The stock tables of most financial publications list the Corporation as "Hershy."

	Common Stock—Approximate Share Volume	
Year	Annual Composite Trading	Average Daily
1985	8,566,000	34,000
1984	7,852,000	31,000
1983	5,339,000	21,000

	Common Stock Price			Dividend	
1985	High	Low	Close	Common	Class B
1st Qtr.	$42⅛	$35	$42	$.35	$.315
2nd Qtr.	49⅜	39¼	47¼	.35	.315
3rd Qtr.	49⅛	42⅞	45⅛	.35	.315
4th Qtr.	55	44⅝	51½	.375	.34

ANNUAL MEETING

The Annual Meeting of Stockholders will be held at 2:00 p.m. on Monday, April 28, 1986, at the Hershey Theatre, East Caracas Avenue (near Cocoa Avenue) in Hershey, Pa.

A formal notice of this meeting, together with a proxy statement, is being mailed to stockholders on or about March 7, 1986.

Voting results and highlights of the meeting will be mailed to stockholders in May 1986 as part of the First Quarter Report to Stockholders.

DIVIDEND POLICY

Dividends on both the Corporation's Common Stock and Class B Common Stock are declared by the Board of Directors, and are normally paid in the months of March, June, September and December. The dividend on the Common Stock to be paid in March 1986 will be the 225th consecutive regular dividend paid by the Corporation.

AUTOMATIC DIVIDEND REINVESTMENT SERVICE

Stockholders may build their investment in Hershey by enrolling in the Corporation's Automatic Dividend Reinvestment Service.

Brokerage commissions and agent fees associated with the service are paid by Hershey. For information, write to the Corporation's Investor Relations Department in Hershey, or the Dividend Reinvestment Department of Manufacturers Hanover Trust Company, P.O. Box 24850, Church Street Station, New York, N.Y. 10249.

PUBLICATIONS FOR STOCKHOLDERS

In addition to this Annual Report, Hershey informs stockholders about news through:

Quarterly Reports—mailed in February, May, August and November.

Notice of Annual Meeting of Stockholders and Proxy Statement—mailed to stockholders in early March.

Form 10-K—filed annually in March with the Securities and Exchange Commission. Stockholders may obtain a free copy of this report upon written request to the Office of the Secretary, Corporate Administrative Center, Hershey Foods Corporation, P.O. Box 814, Hershey, Pa. 17033-0814.

Financial Fact Book—a compendium of additional financial data designed primarily to meet the needs of analysts and portfolio managers. A copy may be obtained from the Corporation's Investor Relations Department.

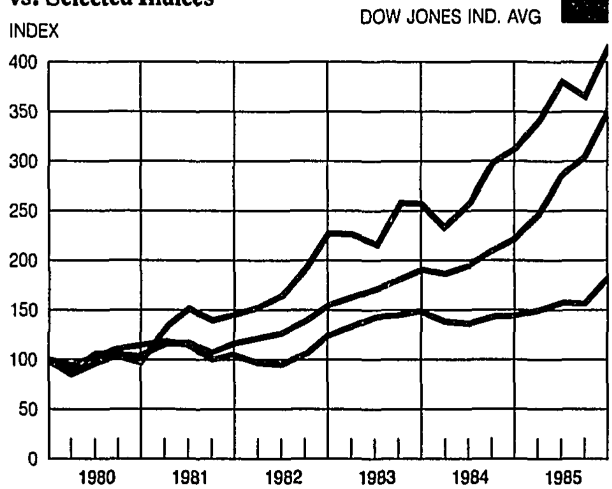
The Corporation maintains a mailing list for those street-name stockholders who wish to receive published information on a timely basis. Stockholders on the list will have reports mailed directly to them, rather than through a third party. For more information, contact the Corporation's Investor Relations Department.

FOR MORE INFORMATION

For information about your stockholder account, please contact the Corporation's transfer agent, Manufacturers Hanover Trust Company, P.O. Box 24935, Church Street Station, New York, N.Y. 10249. Be sure to mention Hershey Foods Corporation and include an account number in any correspondence.

Hershey maintains an active investor relations program to keep stockholders well-informed and to attract new investors. Comments or requests for information should be directed to the Investor Relations Department, Corporate Administrative Center, Hershey Foods Corporation, P.O. Box 814, Hershey, Pa. 17033-0814.

Hershey Foods Common Stock Performance vs. Selected Indices



Financial Review

Earl O'Neal (left), Manager, Computer Services—43 years, and Victor Frye, Data Control Coordinator—15 years, Hershey Chocolate Company.

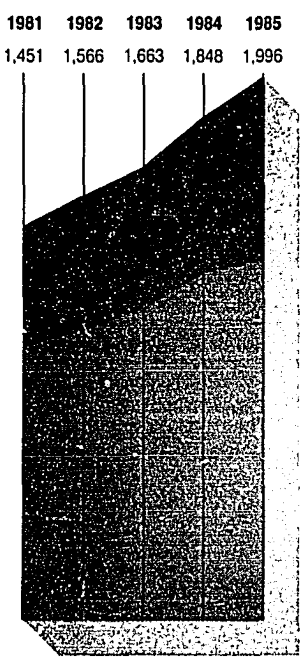
CONTENTS

The Corporation operates in three industry segments: Chocolate and Confectionery, Restaurant Operations and Other Food Products. Operations in the Chocolate and Confectionery segment involve manufacture and sale of a broad line of chocolate and confectionery products. The principal product groups sold are bar goods, bagged items, baking ingredients, chocolate drink mixes and dessert toppings. The Restaurant Operations segment is engaged in the operation of restaurants (752 at December 31, 1985) and the manufacture of certain products sold in those restaurants. The Other Food Products segment is involved in the manufacture and sale of pasta products in the U.S. and Brazil, and biscuit and margarine products in Brazil.

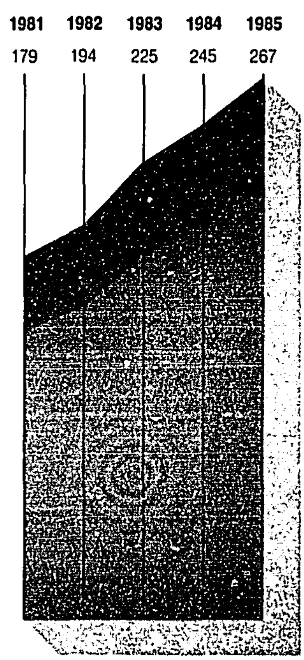
The schedule on page 22 presents net sales, operating income, identifiable assets and other information for the three industry segments. Additional financial information is contained in the Six-Year Consolidated Financial Summary on page 40. The impact of inflation is presented on pages 38 and 39, in accordance with Statements of Financial Accounting Standards Nos. 33 and 82.

The average number of outstanding shares of Common Stock and Class B Common Stock was 31,337,112 in 1985, 1984 and 1983.

Net Sales by Industry Segment
(dollars in millions)



Operating Income by Industry Segment
(dollars in millions)



CHOCOLATE AND CONFECTIONERY
RESTAURANT OPERATIONS
OTHER FOOD PRODUCTS

In November 1985, the Corporation sold the stock of Cory Food Services, Inc. and Cory Canada Inc. ("Cory"). Accordingly, the Consolidated Statements of Income for 1984 and 1983 have been restated for discontinued operations.

The following discussion relates to continuing operations. Information on discontinued operations is contained in Note 3 to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Consolidated

The Corporation experienced sales and earnings growth in 1985 and 1984. Consolidated net sales have increased during this two-year period by an annual compounded growth rate of 10%, with unit volumes and selling prices contributing equally to the increase. Income from continuing operations has increased by an annual compounded growth rate of 9% during the two-year period. An increase in gross profit margins was offset by higher effective income tax rates. The effective income tax rate increased to 48.2% in 1985 from 47.1% in 1983.

Gross profit margins increased in both years because selected selling price increases, together with manufacturing efficiencies, have more than offset the impact of slightly higher major commodity costs. Increased gross profit margins in both years were partially offset by higher levels of selling and marketing expenditures.

Net interest expense increased in 1985 compared with 1984, primarily related to higher foreign borrowing levels. Net interest expense decreased in 1984 compared with 1983, reflecting higher interest income and substantially lower short-term borrowing levels in 1984.

Net Sales

Consolidated net sales in 1985 of $1,996.2 million rose $147.7 million or 8% over 1984, with most of the increase resulting from higher sales volumes. More than half of the sales growth in the Chocolate and Confectionery segment was attributable to volume increases, while the majority of the Restaurant Operations segment net sales increase related to higher selling prices. The net sales increase for the Other Food Products segment consisted principally of unit volume growth relating to American Beauty, the assets and business of which were acquired in November 1984.

Consolidated net sales in 1984 of $1,848.5 million increased $185.8 million or 11% over 1983 consolidated net sales. This increase was attributable to selling price increases and higher unit volumes in all industry segments.

Unit volume increases in both years related to acquired businesses, new product introductions, new restaurants and expanded product distribution, in addition to increased sales volumes of existing products.

Income from Continuing Operations

Income from continuing operations rose 9% to $120.6 million in 1985 and income per share from

continuing operations increased 9% to $3.85 compared with $3.52 in 1984. Gross profit margins were 32.1% in 1985 and 31.3% in 1984. Selling price increases and stable costs of most raw materials in 1985 more than offset the effects of higher costs of cocoa beans and restaurant labor. The 11% increase in selling, general and administrative expenses reflects increased expenditures to support existing products in highly competitive markets. Net interest expense increased from $10.3 million in 1984 to $11.9 million in 1985 due to higher foreign borrowing costs. The effective income tax rate increased from 48.0% in 1984 to 48.2% in 1985.

Income from continuing operations increased by $9.5 million or 9% during 1984 compared with 1983. Income per share from continuing operations was $3.52 compared with $3.22 in 1983. Gross profit margins increased from 31.1% in 1983 to 31.3% in 1984, reflecting selling price increases and manufacturing and distribution efficiencies. The 15% increase in selling, general and administrative expenses primarily reflects higher selling and marketing expenses. Net interest expense decreased from $15.8 million in 1983 to $10.3 million in 1984. The effective income tax rate increased from 47.1% in 1983 to 48.0% in 1984.

Chocolate and Confectionery

In 1985, the Chocolate and Confectionery segment's net sales grew $49.8 million or 4%. This followed an increase of $128.0 million or 11% in 1984 compared with 1983. Both increases were attributable to unit volume gains and higher selling prices.

Operating income in 1985 increased $16.9 million or 9% compared with 1984. The operating margin (income from operations as a percentage of net sales) was higher in 1985 than in 1984, as stable-to-lower costs for most raw materials, manufacturing and distribution efficiencies, and increases in selling prices more than offset the higher cost of cocoa beans and slightly higher selling and marketing expenses. Selling and marketing expenses increased primarily as a result of higher levels of trade promotions and advertising, partly offset by lower consumer promotion expense.

In 1984, operating income increased $16.6 million or 9% compared with 1983. The operating margin was slightly lower in 1984 than in 1983. Commodity cost increases, particularly cocoa beans and sugar, and higher selling and marketing expenses were substantially offset by increases in selling prices. Selling and marketing expenses increased primarily as a result of higher levels of advertising and promotions.

In January 1986, the selling price of the Hershey Chocolate Company's standard chocolate bar line was increased an average of 14%. As a result, the consumer price is expected to increase from $.35 to $.40 in most retail outlets. This price increase had no significant effect on shipments to customers during 1985. The products involved in this change were last increased in price in December 1983.

Restaurant Operations

Net sales for the Restaurant Operations segment grew by $44.4 million or 10% in 1985 compared with 1984. This followed an increase of $43.6 million or 11% in 1984 compared with 1983. Sales growth in 1985 was attributable to selling price increases and volume gains. New restaurant openings and expanded menu offerings contributed to volume growth in 1985. Established restaurants experienced a slight volume decrease. Increased sales in 1984 were primarily due to volume gains relating to new restaurant openings, greater volume in existing restaurants and sales of new products.

In 1985, operating income increased $1.5 million or 4% compared with 1984. Operating margins decreased in 1985 because of higher restaurant labor costs, partly offset by higher selling prices. In 1985, Friendly opened 40 restaurants at new locations and added 12 restaurants as the result of the acquisition of Marvin Franklin Enterprises, Inc. In 1984, Friendly opened 47 restaurants.

During 1984, operating income increased $2.3 million or 6% compared with 1983. Operating margins declined in 1984, reflecting higher restaurant labor and other operating expenses and higher start-up costs as a result of the increased number of restaurant openings.

Other Food Products

Net sales for the Other Food Products segment increased $53.5 million or 40% in 1985 compared with 1984. Higher net sales were achieved by all operations comprising the segment. The majority of the sales increase related to pasta unit volume growth associated with American Beauty (the assets and business of which were acquired in November 1984). Increased sales volume for Petybon more than offset the translation effect of the lower cruzeiro exchange rate relative to the U.S. dollar and Brazilian government price controls.

Net sales for the Other Food Products segment in 1984 increased $14.2 million or 12% compared with 1983, because of both higher volume sales and selling prices from all operations.

Operating income in 1985 increased $3.3 million or 43% compared with 1984. The increase in operating income primarily reflects the inclusion of American Beauty in 1985. Domestic pasta operating margin was approximately equal to prior year as lower commodity costs and selected selling price increases were offset by higher selling and marketing expenditures as a percentage of net sales.

In 1984, operating income increased $1.5 million or 24% compared with 1983. Domestic pasta operations experienced slightly improved operating margins as selected selling price increases were implemented and selling and marketing expenditures decreased as a percentage of net sales.

Industry Segment Data

(in thousands of dollars)

For the years ended December 31,	1985	1984	1983
Net sales: (1)			
Chocolate and Confectionery	$1,336,909	$1,287,100	$1,159,065
Restaurant Operations	471,488	427,122	383,543
Other Food Products(2)	187,757	134,270	120,055
Total net sales	$1,996,154	$1,848,492	$1,662,663
Income from continuing operations before interest and income taxes:			
Chocolate and Confectionery	$ 212,717	$ 195,810	$ 179,253
Restaurant Operations	43,309	41,770	39,428
Other Food Products(2)	11,024	7,726	6,208
General corporate expenses	(22,208)	(22,464)	(18,208)
Income from continuing operations before interest and income taxes	244,842	222,842	206,681
Interest expense, net	(11,929)	(10,349)	(15,814)
Income from continuing operations before income taxes	232,913	212,493	190,867
Less: Provision for income taxes	112,264	102,058	89,895
Income from continuing operations	$ 120,649	$ 110,435	$ 100,972
Identifiable Assets at December 31:(3)			
Chocolate and Confectionery	$ 611,425	$ 580,586	$ 552,422
Restaurant Operations	310,955	273,356	251,781
Other Food Products	120,763	152,747	84,964
Corporate	154,289	115,878	94,777
Total assets	$1,197,432	$1,122,567	$ 983,944
Depreciation:			
Chocolate and Confectionery	$ 20,171	$ 17,636	$ 14,393
Restaurant Operations	21,616	18,874	17,066
Other Food Products(2)	6,761	3,733	2,893
Corporate	1,096	1,079	1,218
Total depreciation	$ 49,644	$ 41,322	$ 35,570
Capital additions:			
Chocolate and Confectionery	$ 51,895	$ 37,508	$ 51,779(5)
Restaurant Operations	53,330	41,885	35,751
Other Food Products(2)	6,947	4,311	5,476
Corporate(4)	2,277	3,345	12,238
Total capital additions	$ 114,449	$ 87,049	$ 105,244

(1)No customer, government or other entity accounts for 10% or more of sales. Intersegment sales are not separately stated because such sales are not significant. Foreign sales and assets account for less than 10% of total sales and assets.
(2)Net sales, income from continuing operations, depreciation and capital additions for the Other Food Products segment have been restated to reflect the sale of Cory Food Services, Inc. and Cory Canada Inc.
(3)Identifiable assets are those assets that are used in the Corporation's operations in each segment. Corporate assets are principally cash and short-term investments, and corporate property and equipment.
(4)Corporate capital additions include capital additions of discontinued operations through the date of disposition.
(5)These capital additions include approximately $11 million for the construction of the Eastern Distribution Center, subsequently included in a sale and leaseback transaction.

General Corporate Expenses

General corporate expense amounts were comparable in 1985 and 1984. These expenses increased by 23% in 1984 compared with 1983, reflecting expenditures for professional and consulting services, facilities expenses, other administrative costs and certain nonoperating income and expense items.

FINANCIAL CONDITION

The Corporation's overall financial condition has remained solid and liquidity improved during 1985. Cash and short-term investments increased $22.7 million, with capital additions ($114.4 million), dividends ($43.9 million) and the purchase of the stock of Marvin Franklin Enterprises, Incorporated ($6.5 million, net of working capital acquired) being financed from internally generated funds. After a net $20.5 million increase in working capital, cash provided from continuing operations was $188.9 million in 1985. Working capital increases relate to investments in inventories and a reduction in accounts payable. The accounts payable reduction relates to a change in the timing of raw material deliveries between the years.

The ratio of current assets to current liabilities was 2.1:1 at December 31, 1985, 1.9:1 in 1984 and 2.2:1 in 1983.

Over the past three years, income from continuing operations has been the Corporation's principal source of funds. Internally generated funds have been more than sufficient to finance the Corporation's investment activities during this period. Investment activities, which are vital to the Corporation's continued growth, included capital expenditures for new manufacturing equipment and construction of distribution and restaurant facilities. Additionally, the Corporation used internally generated funds to purchase the assets of American Beauty in 1984.

The Corporation's sales, income from continuing operations and related working capital requirements are affected by seasonal sales patterns. Chocolate and Confectionery segment seasonal and holiday-related sales are typically highest during the third and fourth quarters of the year, representing the principal seasonal effect on the Corporation. Restaurant Operations segment sales are highest in the second and third quarter warm weather seasons, while domestic pasta sales are somewhat higher during the cooler weather periods.

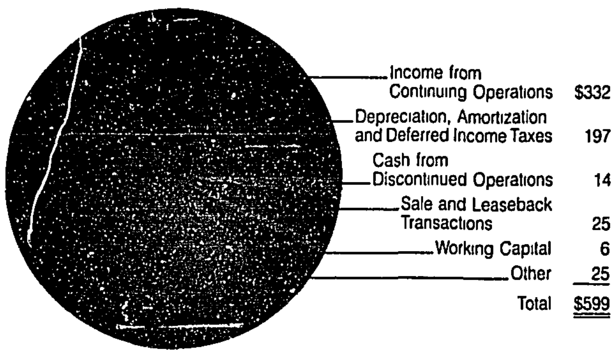
Historically, the Corporation's domestic seasonal working capital needs have often exceeded funds generated from normal operations and, therefore, interim financing was required. These needs were met by issuing commercial paper and/or borrowing from commercial banks. Typically, the Corporation's seasonal needs for working capital peaked during the summer months and domestic short-term borrowings were generally repaid in the fall. In 1984, only minimal domestic short-term borrowings were required to fund seasonal working capital requirements and no seasonal borrowings were required in 1985.

At December 31, 1985, the Corporation had $4.8 million of outstanding short-term debt related entirely to Brazilian operations, $4.8 million current portion of long-term debt and $110.6 million of cash and short-term investments. Bank lines of credit which may be borrowed directly or used to support the issuance of commercial paper were $100 million. In 1985, 1984, and 1983, the Corporation repurchased $14.4 million, $4.5 million and $11.0 million, respectively, of its sinking fund debentures and other obligations to meet future sinking fund requirements.

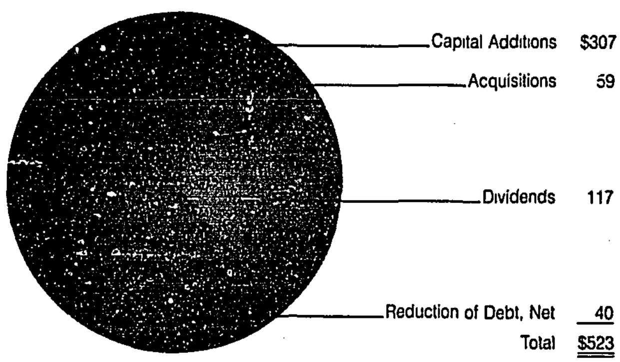
In 1983, sale and leaseback transactions generated proceeds of $32.5 million ($25.5 million, net of deferred gain), which were used to reduce short-term debt. No other long-term financing arrangements were required during the 1983-1985 period to meet capital expenditures or other requirements.

By amendment and restatement of the Corporation's Restated Certificate of Incorporation, effective October 9, 1984, the authorized number of shares of the Corporation's capital stock was increased from 52,000,000 to 230,000,000. Of this amount, 150,000,000 shares were designated as Common Stock, 75,000,000 shares as Class B Common Stock ("Class B Stock"), and 5,000,000 shares as Preferred Stock, each class having a par value of one dollar per share. Shares of the

Three-Year Principal Sources of Funds
(dollars in millions)



Three-Year Principal Uses of Funds
(dollars in millions)



Common Stock carry one vote per share and the Class B Stock ten votes per share.

The recapitalization enables the Corporation to issue shares of the Common Stock to finance its future growth, without adversely affecting the voting control of Hershey Trust Company, as Trustee for Milton Hershey School, whose approval is required prior to the Corporation issuing shares of the Common Stock above certain levels.

The Corporation's long-term debt as a percentage of stockholders' equity was 15% in 1985, 19% in 1984 and 21% in 1983. The decreases in 1985 and 1984 resulted from increased stockholders' equity attributable to net income in excess of dividends, together with reductions in long-term debt.

At December 31, 1985, the Corporation's principal capital commitments included the installation of manufacturing equipment, the construction of a distribution facility for existing and new products and the construction of FRIENDLY restaurants.

MARKET PRICES AND DIVIDENDS

Cash dividends paid on the Corporation's Common Stock and Class B Common Stock ("Class B Stock") were $43.9 million in 1985 and $38.7 million in 1984. The annual dividend rate on the Common Stock was increased 7% in 1985 to $1.50 per share from $1.40 per share in 1984. The 1985 dividend represents the 11th consecutive year of Common Stock dividend increases.

On February 12, 1986, the Corporation declared a regular quarterly dividend of $.375 per share of the Common Stock payable on March 14, 1986, to stockholders of record February 28, 1986. It is the Corporation's 225th consecutive regular Common Stock dividend. A regular quarterly dividend of $.34 per share of the Class B Stock was also declared. The cash dividend on shares of the Common Stock is required to be 10% higher than those on the Class B Stock.

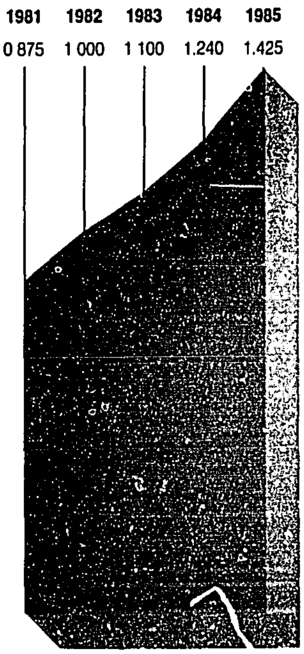
Hershey Foods Corporation Common Stock is listed and traded principally on the New York Stock Exchange under the symbol HSY. Approximately 8.6 million shares of the Corporation's Common Stock were traded during 1985. The closing price of the Common Stock on the New York Stock Exchange on December 31, 1985, was $51.50. The Class B Stock is not publicly traded. There were 17,529 stockholders of record of the Common Stock and the Class B Stock at December 31, 1985.

The New York Stock Exchange has a policy against listing the common stock of companies which have more than one class of common stock with unequal voting power. A review of this policy was begun in July 1984, and in January 1985, the Exchange's Subcommittee on Shareholder Participation and Qualitative Listing Standards recommended that Exchange-listed companies be allowed to have different classes of common stock with unequal voting power, provided that certain conditions are met. The review of the Exchange's policy and the Subcommittee's recommendation is still ongoing. To be implemented, the recommendation would require the approval of the Exchange's Public

	Dividends Paid Per Share		Common Stock Price Range**	
	Common Stock	Class B Stock*	High	Low
1985				
1st Quarter	$ .35	$ .315	$42⅛	$35
2nd Quarter	.35	.315	49⅜	39¼
3rd Quarter	.35	.315	49⅛	42⅞
4th Quarter	.375	.34	55	44⅝
	$1.425	$1.285		
1984				
1st Quarter	$ .2875	$ —	$32⅞	$28¼
2nd Quarter	.2875	—	32⅝	28½
3rd Quarter	.315	—	38⅜	30⅝
4th Quarter	.35	.315	41¼	35
	$1.24	$ .315		

*The Class B Stock was issued in the fourth quarter of 1984.
**NYSE-Composite Quotations for Common Stock.

Dividends Paid Per Share of Common Stock
(dollars)



Capital Additions
(dollars in millions)

Policy Committee and Board of Directors, and appropriate regulatory authorities. If the Exchange's current policy is modified in accordance with the recommendation, the Corporation believes its Common Stock would continue to be eligible for trading on the Exchange. If the current policy is not modified, the Corporation's Common Stock would no longer be eligible for trading on the Exchange. In that event, the Corporation would take appropriate steps to have its Common Stock traded on the National Market System of the National Association of Securities Dealers, Inc. The Corporation is of the opinion that any transfer of its Common Stock from the New York Stock Exchange to the National Market System would not materially adversely affect the relationship between the volume of trading and changes in market price for the Common Stock or the ability of investors to purchase and sell shares of the Common Stock.

CAPITAL ADDITIONS

The Corporation regularly invests in capital additions, providing for growth, productivity and capacity sustaining programs. Capital additions, including capitalized interest and property subject to capitalized leases, in 1985 were $114.4 million compared with $87.0 million in 1984 and $105.2 million in 1983.

Chocolate and Confectionery segment additions accounted for $51.9 million or 45% of total spending for 1985 compared with $37.5 million or 43% in 1984. In 1985 and 1984, additions consisted principally of installations of production equipment for new and existing products.

The Restaurant Operations segment accounted for $53.3 million or 47% of the total spending for 1985 compared with $41.9 million or 48% in 1984. Approximately 65% of the spending was for restaurants opened at 40 new locations during 1985 and new restaurant locations scheduled to open subsequent to 1985. Other additions included the renovation and modification of existing restaurants and other improvements. In 1984, 47 restaurants at new locations were opened.

The Other Food Products segment accounted for $6.9 million or 6% of the 1985 total spending compared with $4.3 million or 5% in 1984. The 1984 additions do not include the $26.6 million of American Beauty property, plant and equipment acquired. Additions during 1985 and 1984 primarily related to pasta manufacturing equipment and facilities.

Corporate additions were $2.3 million or 2% of total spending in 1985 compared with $3 3 million or 4% in 1984. Additions during the periods included expansion of research facilities and equipment related to development of new production processes and operating efficiencies.

Depreciation expense and amortization of leasehold improvements and capitalized leases for 1985, 1984 and 1983 amounted to $49.6 million, $41.3 million and $35.6 million, respectively.

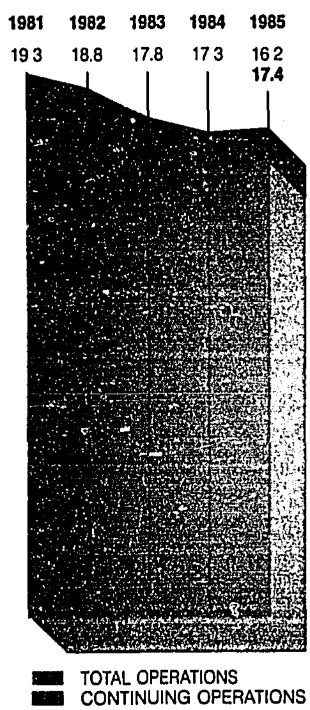
RETURN ON STOCKHOLDERS' EQUITY

The Corporation has increased consolidated net sales, net income and assets in each of the most recent five years. Its return on average stockholders' equity has ranged from 16.2% in 1985 to 19.3% in 1981. Before the loss from discontinued operations, the return on stockholders' equity was 17.4% in 1985. The return since 1981 reflects the effect of reduced long-term debt during the period and of $53 million of additional stockholders' equity resulting from the issuance of 3,000,000 shares of Common Stock in late 1981.

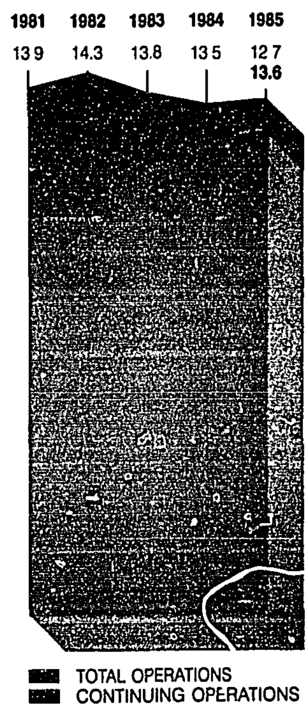
RETURN ON INVESTED CAPITAL

The Corporation's after-tax return on average invested capital over the most recent five-year period has ranged from 12.7% in 1985 to 14.3% in 1982. Before the loss from discontinued operations, the return on invested capital was 13.6% in 1985. Average invested capital consists of the average of beginning and end-of-year balances in long-term debt, deferred income taxes and stockholders' equity. Earnings on invested capital is the sum of net income and the after-tax effect of interest on long-term debt.

Return on Average Stockholders' Equity
(percent)



After-Tax Return on Average Invested Capital
(percent)



HERSHEY FOODS CORPORATION

Consolidated Statements of Income

(in thousands of dollars except per share amounts)

For the years ended December 31,	1985	1984	1983
Net Sales	**$1,996,154**	$1,848,492	$1,662,663
Costs and Expenses:			
Cost of sales	**1,355,789**	1,269,801	1,145,867
Selling, general and administrative	**395,523**	355,849	310,115
Total costs and expenses	**1,751,312**	1,625,650	1,455,982
Income from Continuing Operations before Interest and Income Taxes	**244,842**	222,842	206,681
Interest expense, net (Note 1)	**11,929**	10,349	15,814
Income from Continuing Operations before Income Taxes	**232,913**	212,493	190,867
Provision for income taxes (Note 4)	**112,264**	102,058	89,895
Income from Continuing Operations	**120,649**	110,435	100,972
(Loss) from Discontinued Operations (Note 3)	**(8,422)**	(1,753)	(806)
Net Income	**$ 112,227**	$ 108,682	$ 100,166
Income (Loss) per Share (Note 2)			
Continuing Operations	**$ 3.85**	$ 3.52	$ 3.22
Discontinued Operations	**(.27)**	(.05)	(.02)
Net Income	**$ 3.58**	$ 3.47	$ 3.20

Cash Dividends Paid per Share of Common Stock (Note 2)	**$ 1.425**	$ 1.24	$ 1.10
Cash Dividends Paid per Share of Class B Common Stock (Note 2)	**1.285**	.315	—
Income from Continuing Operations before Interest and Income Taxes as a Percentage of Net Sales	**12.3%**	12.1%	12.4%
Income from Continuing Operations as a Percentage of Net Sales	**6.0%**	6.0%	6.1%

The notes to consolidated financial statements are an integral part of these statements.

HERSHEY FOODS CORPORATION

Consolidated Statements of Changes in Financial Position

(in thousands of dollars)

For the years ended December 31,	1985	1984	1983
Cash Provided from (Used by) Continuing Operations			
Income from continuing operations	$ 120,649	$ 110,435	$ 100,972
Depreciation and amortization	52,351	42,770	37,095
Deferred income taxes	30,268	22,454	12,150
Working capital provided from continuing operations	203,268	175,659	150,217
Changes in working capital (excluding cash and short-term investments and debt):			
Inventories	(6,725)	8,713	(16,081)
Accounts receivable	4,360	(24,521)	8,673
Accounts payable	(8,579)	29,271	5,136
Other	(9,602)	3,167	12,232
Other long-term liabilities	6,136	2,713	13,017
Cash provided from continuing operations	188,858	195,002	173,194
Cash Provided from Discontinued Operations	12,062	638	1,198
Cash Dividends Paid	(43,942)	(38,680)	(34,470)
Cash Provided from (Used for) Investment Transactions			
Capital additions	(114,449)	(87,049)	(105,244)
Business acquisitions, net of working capital acquired	(6,479)	(52,199)	—
Sale and leaseback transactions, net of deferred gain	—	—	25,480
Other	(1,117)	(931)	4,298
Cash (used for) investment transactions	(122,045)	(140,179)	(75,466)
Reduction of Debt, net	(12,214)	(1,955)	(25,868)
Increase in Cash and Short-Term Investments	22,719	14,826	38,588
Cash and Short-Term Investments at January 1	87,917	73,091	34,503
Cash and Short-Term Investments at December 31	$ 110,636	$ 87,917	$ 73,091

The notes to consolidated financial statements are an integral part of these statements.

Consolidated Balance Sheets

(in thousands of dollars)

December 31,	1985	1984
ASSETS		
Current Assets:		
Cash and short-term investments (Note 1)	$ 110,636	$ 87,917
Accounts receivable—trade (less allowances for doubtful accounts of $4,151 and $3,362)	76,617	80,977
Inventories (Note 1)	192,678	185,953
Other current assets	32,359	30,474
Total current assets	412,290	385,321
Property, Plant and Equipment, at cost: (Note 1)		
Land	62,906	57,549
Buildings	221,901	199,129
Machinery and equipment	680,121	615,055
Capitalized leases	33,274	29,986
	998,202	901,719
Less—accumulated depreciation and amortization	296,435	259,110
	701,767	642,609
Intangibles Resulting from Business Acquisitions (Note 1)	66,240	79,252
Investments and Other Assets (Note 1)	17,135	15,385
	$1,197,432	$1,122,567

December 31,	1985	1984
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable (Note 5)	$ 87,799	$ 96,378
Accrued liabilities		
Payroll and other compensation costs	37,275	35,965
Advertising and promotional expenses	19,828	20,607
Other	31,544	28,986
	88,647	85,558
Accrued income taxes	9,253	14,247
Short-term debt and current portion of long-term debt (Notes 5 and 6)	9,623	6,770
Total current liabilities	195,322	202,953
Long-Term Debt (Notes 6 and 7)	110,169	125,236
Other Long-Term Liabilities	31,216	25,080
Deferred Income Taxes (Note 4)	132,826	108,370
Stockholders' Equity: (Note 2)		
Common Stock, $1 par value, outstanding shares: 26,235,710 in 1985; 26,235,110 in 1984	26,236	26,235
Class B Common Stock, $1 par value, outstanding shares: 5,101,402 in 1985; 5,102,002 in 1984	5,101	5,102
Additional paid-in capital	54,006	54,006
Cumulative foreign currency translation adjustments	(8,579)	(7,265)
Retained earnings	651,135	582,850
Total stockholders' equity	727,899	660,928
	$1,197,432	$1,122,567

The notes to consolidated financial statements are an integral part of these balance sheets.

HERSHEY FOODS CORPORATION

Consolidated Statements of Stockholders' Equity

(in thousands of dollars)

	Common Stock	Class B Common Stock	Additional Paid-In Capital	Cumulative Foreign Currency Translation Adjustments	Retained Earnings	Total Stockholders' Equity
Balance at January 1, 1983	$15,669	$ —	$54,006	$ —	$462,820	$532,495
Effect of change in accounting for foreign currency translation (Note 1)				(1,542)		(1,542)
Net income					100,166	100,166
Dividends—Common Stock					(34,470)	(34,470)
Stock split (Note 2)	15,668				(15,668)	—
Foreign currency translation adjustments (Note 1)				(612)		(612)
Balance at December 31, 1983	31,337	—	54,006	(2,154)	512,848	596,037
Exchange of Common Stock (Note 2)	(5,102)	5,102				—
Net income					108,682	108,682
Dividends—Common Stock (Note 2)					(37,073)	(37,073)
Dividends—Class B Common Stock (Note 2)					(1,607)	(1,607)
Foreign currency translation adjustments (Note 1)				(1,721)		(1,721)
Adoption of equity method of accounting for AB Marabou (Note 3)				(3,390)		(3,390)
Balance at December 31, 1984	26,235	5,102	54,006	(7,265)	582,850	660,928
Net income					112,227	112,227
Dividends—Common Stock (Note 2)					(37,385)	(37,385)
Dividends—Class B Common Stock (Note 2)					(6,557)	(6,557)
Foreign currency translation adjustments (Note 1)				(1,314)		(1,314)
Conversion of Class B Common Stock into Common Stock (Note 2)	1	(1)				—
Balance at December 31, 1985	$26,236	$5,101	$54,006	$(8,579)	$651,135	$727,899

The notes to consolidated financial statements are an integral part of these statements.

Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies employed by the Corporation are discussed below and in Notes 4 and 8. As described in Note 3, the disposition of Cory Food Services, Inc. and Cory Canada Inc. ("Cory") is reflected in the accompanying consolidated financial statements as discontinued operations. Accordingly, restatements have been made to prior year amounts to conform to the 1985 presentation.

Principles of Consolidation

The consolidated financial statements include the accounts of the Corporation and its subsidiaries after elimination of intercompany accounts and transactions.

Investments

Short-term investments are stated at the lower of cost or market. Investments in affiliated companies accounted for on the equity method are included in "Investments and Other Assets."

Commodities Futures Contracts

In connection with the procurement of major commodities, principally cocoa and sugar, the Corporation enters into commodities futures contracts as deemed appropriate to reduce its exposure to future price increases for anticipated manufacturing requirements. Gains and losses on such futures contracts are deferred and recognized in cost of sales when the related product is manufactured and sold.

Foreign Currency Translation

For foreign entities, assets and liabilities are translated to U.S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates during the period. Resulting translation adjustments are recorded in a separate component of stockholders' equity, "Cumulative Foreign Currency Translation Adjustments." For foreign entities operating in highly inflationary economies, nonmonetary assets and liabilities are translated at historical exchange rates and related translation gains and losses are included in results of operations. Foreign exchange gains and losses included in the consolidated statements of income were not material.

Inventories

Substantially all of the Chocolate and Confectionery and certain Other Food Products inventories are valued under the last-in, first-out ("LIFO") method at amounts that do not exceed realizable values. The remaining inventories are stated at the lower of first-in, first-out ("FIFO") cost or market. The LIFO cost of inventories valued using the LIFO method was $139,717,000 in 1985 and $131,491,000 in 1984. Total year-end inventories were as follows:

December 31,	1985	1984
(in thousands of dollars)		
Raw materials	**$126,879**	$117,842
Goods in process	**26,936**	31,161
Finished goods	**126,786**	122,200
Inventories at FIFO	**280,601**	271,203
Adjustment to LIFO	**(87,923)**	(85,250)
Total inventories	**$192,678**	$185,953

Property, Plant and Equipment

Depreciation and amortization of buildings, machinery and equipment, and capitalized leases are computed using the straight-line method. Property, plant and equipment balances include construction in progress in the amount of $27,756,000 at December 31, 1985 and $17,671,000 at December 31, 1984.

Intangibles Resulting from Business Acquisitions

Intangible assets resulting from business acquisitions principally consist of the excess of the acquisition cost over the fair value of the net assets of businesses acquired ("goodwill"). Goodwill is amortized on a straight-line basis over periods not exceeding 40 years. Sale of the stock of Cory in 1985 resulted in a goodwill reduction of approximately $10,600,000.

Other intangible assets are amortized on a straight-line basis over their estimated useful lives.

Promotion and Development Expenses

The costs of advertising and promotion ($193,036,000 in 1985, $176,891,000 in 1984 and $149,747,000 in 1983) and research and development ($11,181,000 in 1985, $9,932,000 in 1984 and $8,682,000 in 1983) are expensed in the year incurred.

Interest Expense

Interest expense, net consisted of the following:

For the years ended December 31,	1985	1984	1983
(in thousands of dollars)			
Long-term debt	**$ 9,883**	$10,339	$12,029
Capitalized leases	**2,908**	2,639	1,976
Short-term debt	**8,277**	3,573	5,863
Capitalized interest	**(2,520)**	(1,260)	(3,102)
	18,548	15,291	16,766
Interest and dividend income	**(6,619)**	(4,942)	(952)
	$11,929	$10,349	$15,814

2. CAPITAL STOCK

In 1984, the authorized number of shares of capital stock was increased from 52,000,000 to 230,000,000. Of this amount, 150,000,000 shares were designated as Common Stock, 75,000,000 shares as Class B Common Stock ("Class B Stock"), and 5,000,000 shares as Preferred Stock, each class having a par value of one dollar per share.

In general terms, the Common Stock has greater dividend rights, but lesser voting power, than the Class B Stock. The Common Stock and the Class B Stock generally vote together without regard to class on matters submitted to stockholders, including the election of directors, with the Common Stock having one vote per share and the Class B Stock having 10 votes per share. However, the Common Stock, voting separately as a class, is entitled to elect one-sixth of the Board of Directors. With respect to dividend rights, the Common Stock is entitled to cash dividends 10% higher than those declared and paid on the Class B Stock.

Shares of the Class B Stock were issued in a one-time-only exchange offer to Common Stock holders on a share-for-share basis in late 1984. Class B Stock can be converted into Common Stock on a share-for-share basis at any time. During 1985, 600 shares of Class B Stock were converted into Common Stock. At December 31, 1985, there was a combined total of 31,337,112 shares of both classes outstanding. No shares of the Preferred Stock were issued or outstanding.

Hershey Trust Company, as Trustee for Milton Hershey School, owned 10,642,831 shares of the Common Stock, and 5,051,001 shares of the Class B Stock at December 31, 1985.

Net income per share has been computed based on the weighted average number of shares of the Common Stock and the Class B Stock outstanding during the year as adjusted for the two-for-one stock split effective September 15, 1983 (31,337,112 in 1985, 1984 and 1983). The Common Stock dividends have also been adjusted for the two-for-one stock split.

3. ACQUISITIONS AND DIVESTITURES

On November 22, 1985, the Corporation sold the stock of Cory Food Services, Inc. and Cory Canada Inc., wholly-owned subsidiaries of the Corporation. Net of an income tax benefit of $2.6 million, the loss on disposal was $7.0 million or $.22 per share. Cory's operating loss in 1985, net of an income tax benefit of $0.9 million, was $1.4 million or $.05 per share.

The consolidated statements of income have been restated for discontinued operations for the years presented. The "Loss from Discontinued Operations" includes both the loss on disposal and operating results of Cory. Prior year balance sheets have not been restated.

Net sales for Cory were $39.1 million, $44.0 million and $43.4 million for the 11 months in 1985 and for the years 1984 and 1983, respectively.

On September 30, 1985, the Corporation purchased the stock of Marvin Franklin Enterprises, Inc. ("Franklin"). Franklin is a chain of 12 full-service family restaurants located in Pennsylvania. Franklin's results subsequent to the acquisition date are included in the consolidated financial statements.

In November 1984, the Corporation purchased the inventory, buildings, land, machinery and equipment, trademarks and certain other intangible assets of American Beauty (a division of The Pillsbury Company) for approximately $56.0 million, and assumed certain liabilities. The acquisition was accounted for as a purchase, and accordingly, American Beauty results subsequent to the acquisition date are included in the consolidated financial statements.

In mid-1984, the Corporation purchased, for $1.7 million, an additional interest in AB Marabou, a confectionery company in Sweden, thereby increasing the Corporation's ownership interest from 17% to 20%. Accordingly, the Corporation adopted the equity method of accounting for Marabou's results of operations during 1984.

Had the results of the Franklin, American Beauty and Marabou acquisitions been included with consolidated results for the entire period 1983 through 1985, the effect would not have been material.

4. INCOME TAXES

The provision for Federal and state income taxes is based on income from continuing operations before income taxes as reported in the financial statements. Income tax benefits related to the discontinued operations are included in the "Loss from Discontinued Operations" in the Consolidated Statements of Income. Investment and other tax credits are recognized as a reduction in the provision using the flow-through method.

Deferred income taxes are provided to reflect timing differences between reported results of operations for financial statement and income tax purposes. Timing differences relate primarily to accelerated depreciation, employee benefit plan contributions and deferred gains on sale and leaseback transactions. Such gains were taxable in 1983 but are amortized over lease terms for financial statement purposes. The provision for income taxes on income from continuing operations was as follows:

For the years ended December 31,	1985	1984	1983
(in thousands of dollars)			
Current	**$ 81,996**	$ 79,604	$77,745
Deferred	**30,268**	22,454	12,150
Provision for income taxes	**$112,264**	$102,058	$89,895

The following table reconciles the provision for income taxes with the amount computed by applying the Federal statutory rate.

For the years ended December 31,	1985		1984		1983	
	Amount	**%**	Amount	%	Amount	%
(in thousands of dollars)						
Income taxes computed at statutory rate	**$107,140**	**46.0**	$ 97,747	46.0	$87,799	46.0
Increase (reduction) resulting from:						
State income taxes, net of Federal income tax benefits	**10,857**	**4.7**	10,073	4.7	9,312	4.9
Investment tax credit	**(5,348)**	**(2.3)**	(4,618)	(2.2)	(5,561)	(2.9)
Nondeductible acquisition costs	**1,718**	**.7**	1,583	.7	2,068	1.1
Payroll tax credits and other	**(2,103)**	**(.9)**	(2,727)	(1.2)	(3,723)	(2.0)
Provision for income taxes	**$112,264**	**48.2**	$102,058	48.0	$89,895	47.1

5. SHORT-TERM DEBT

The Corporation maintained lines of credit arrangements with commercial banks, under which it could borrow up to $100 million in 1985 and 1984 at the lending banks' prime commercial interest rates or lower. These lines of credit, which may be used to support commercial paper borrowings, may be terminated at the option of the banks or the Corporation. There were no borrowings under these lines of credit at December 31, 1985 or 1984.

Lines of credit are supported by commitment fee and/or compensating balance arrangements. The fees range up to 3/8% per annum of the commitment. While there are no compensating balance agreements which legally restrict these funds, the Corporation generally maintains balances of up to 4% but not less than 2% of commitments under these lines of credit.

The average outstanding balance of short-term debt, which related to foreign borrowings in Brazil, was $5,901,000 in 1985. Average outstanding short-term debt in 1984 was not significant. Maximum short-term borrowings at any month-end were $10,182,000 in 1985 and $5,354,000 in 1984.

As a result of maintaining a consolidated cash management system, the Corporation maintains overdraft positions at certain banks. Such overdrafts, which are included in accounts payable, were $14,421,000 and $20,901,000 at December 31, 1985 and 1984, respectively.

6. LONG-TERM DEBT

Long-term debt and capitalized lease obligations at December 31, 1985 and 1984 consisted of the following:

(in thousands of dollars)	1985	1984
8.7% Senior Notes due 1992	**$ 14,000**	$ 16,000
7.25% Sinking Fund Debentures due 1997	**1,023**	14,450
6.875% Industrial Revenue Bonds due 2000–2005	**4,000**	4,000
10.4% Industrial Revenue Bonds due 2002	**1,000**	1,000
9.5% Sinking Fund Debentures due 2009	**63,000**	64,000
10.625% Pollution Control Revenue Bonds due 2012	**2,100**	2,100
Other obligations, net	**2,977**	2,747
Capitalized lease obligations	**26,877**	25,645
	114,977	129,942
Less—current portion	**4,808**	4,706
Total long-term debt	**$110,169**	$125,236

In 1985 and 1984, the Corporation repurchased $14,427,000 and $4,500,000, respectively, of sinking fund debentures and other obligations to be used to meet future minimum annual payments.

Aggregate annual maturities and sinking fund requirements, net of repurchased debentures and exclusive of capitalized lease obligations, are: 1986, $2,070,000; 1987, $2,102,000; 1988, $2,341,000; 1989, $5,400,000; 1990, $5,431,000.

7. LEASES

Total rent expense for all operating leases, which pertain principally to certain administrative buildings, distribution facilities, restaurants and transportation equipment, was $22,039,000 in 1985, $19,637,000 in 1984 and $15,856,000 in 1983.

Future minimum lease payments under noncancelable leases with an original term in excess of one year as of December 31, 1985 are shown in the following table.

	Operating Leases	Capital Leases
(in thousands of dollars)		
1986	$ 7,592	$ 5,771
1987	6,813	5,530
1988	6,029	5,178
1989	7,858	3,842
1990	7,460	3,480
1991 and beyond	164,004	24,083
Total minimum lease payments	$199,756	$47,884

The total minimum lease payments under capital leases include $21,007,000 of imputed interest. Capital leases primarily pertain to restaurant facilities and data processing equipment.

8. RETIREMENT PLANS AND OTHER RETIREE BENEFITS

The Corporation and its subsidiaries have several noncontributory retirement plans covering substantially all employees. Pension expense is determined and funded on the basis of accepted actuarial methods and includes current service and prior service costs. Prior service costs and actuarial gains and losses are amortized over 15 to 30 years. Contributions are determined using principally the projected unit credit actuarial method for salaried employees and the frozen entry age actuarial method for hourly employees. Both methods provide for retirement benefits that are funded over the service lives of employees. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits and pension expense was principally 8%.

Accumulated benefits and net assets for the Corporation's defined benefit plans as of the date of the most recent actuarial valuation are as follows:

January 1,	1985	1984
(in thousands of dollars)		
Actuarial present value of accumulated benefits:		
Vested	**$150,722**	$131,494
Nonvested	**6,922**	6,477
	$157,644	$137,971
Market value of net assets available for benefits	**$166,593**	$149,677

The pension expense for these plans was $13,810,000 in 1985, $13,542,000 in 1984 and $12,002,000 in 1983. The pension expense increase in 1985 and 1984 reflects benefit improvements in certain hourly and salaried plans and an increase in the number of participating employees.

In December 1985, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 87, "Employers' Accounting for Pensions." For U.S. retirement plans, companies are required to adopt the new expense and disclosure standards no later than 1987 and, in certain circumstances, to reflect a minimum pension liability no later than 1989. Early adoption is permitted. These new standards will be adopted prospectively, and thus the financial statements included herein will not be restated. The Corporation has not decided whether it will implement early adoption of the new standard. However, the adoption of this statement is not expected to have an adverse impact on the Corporation's financial position.

The Corporation and its subsidiaries provide certain health care and life insurance benefits for retired employees. Substantially all of the Corporation's U.S. employees may become eligible for these benefits at normal retirement age. Retiree health care and life insurance premiums of $2,027,000 and $1,760,000 were expensed as paid during 1985 and 1984, respectively.

9. QUARTERLY DATA (Unaudited)

The following is a summary of quarterly data for the years 1985 and 1984:

(in thousands of dollars except per share amounts)

Year 1985	First	Second	Third	Fourth	Year
Net sales	$476,505	$431,074	$547,724	$540,851	$1,996,154
Gross profit	147,600	135,839	176,522	180,404	640,365
Income from continuing operations	22,962	22,578	39,532	35,577	120,649
(Loss) from discontinued operations	(224)	(504)	(7,694)	—	(8,422)
Net income	22,738	22,074	31,838	35,577	112,227
Income from continuing operations per share	.73	.72	1.26	1.14	3.85
Net income per share	.73	.70	1.01	1.14	3.58

Year 1984	First	Second	Third	Fourth	Year
Net sales	$423,612	$391,749	$520,797	$512,334	$1,848,492
Gross profit	125,997	120,652	166,548	165,494	578,691
Income from continuing operations	19,699	19,374	35,934	35,428	110,435
(Loss) from discontinued operations	(139)	(284)	(672)	(658)	(1,753)
Net income	19,560	19,090	35,262	34,770	108,682
Income from continuing operations per share	.63	.62	1.14	1.13	3.52
Net income per share	.62	.61	1.13	1.11	3.47

10. INDUSTRY SEGMENT AND EFFECTS OF INFLATION

Industry segment information and unaudited information regarding the effects of inflation are shown on pages 20 through 22 and 38 through 39, respectively, of this report.

Responsibility for Financial Statements

Hershey Foods Corporation is responsible for the financial statements and other financial information contained in this report. The Corporation believes that the financial statements have been prepared in conformity with generally accepted accounting principles appropriate under the circumstances to reflect in all material respects the substance of applicable events and transactions. In preparing the financial statements, it is necessary that management make informed estimates and judgments. The other financial information in this annual report is consistent with the financial statements.

The Corporation maintains a system of internal accounting controls designed to provide reasonable assurance that financial records are reliable for purposes of preparing financial statements and that assets are properly accounted for and safeguarded. The concept of reasonable assurance is based on the recognition that the cost of the system must be related to the benefits to be derived. The Corporation believes its system provides an appropriate balance in this regard. The Corporation maintains an Internal Auditing Department which reviews the adequacy and tests the application of internal accounting controls.

The financial statements have been examined by Arthur Andersen & Co., independent public accountants, whose appointment was ratified by stockholder vote at the stockholders' meeting held on April 29, 1985. Their report expresses an opinion that the Corporation's financial statements are fairly stated in conformity with generally accepted accounting principles. Their examination was performed in accordance with generally accepted auditing standards and, accordingly, included reviewing the internal accounting controls and conducting other auditing procedures they deemed necessary.

The Audit Committee of the Board of Directors of the Corporation, consisting solely of outside directors, meets regularly with the independent public accountants, internal auditors and management to discuss, among other things, the audit scopes and results. Arthur Andersen & Co. and the internal auditors both have full and free access to the Audit Committee, with and without the presence of management.

Report of Independent Public Accountants

To the Stockholders and Board of Directors
of Hershey Foods Corporation:

We have examined the consolidated balance sheets of Hershey Foods Corporation (a Delaware corporation) and subsidiaries as of December 31, 1985 and 1984 and the related consolidated statements of income, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Hershey Foods Corporation and subsidiaries as of December 31, 1985 and 1984 and the results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1985 in conformity with generally accepted accounting principles applied on a consistent basis.

New York, N.Y.
February 7, 1986

Arthur Andersen & Co.

Supplementary Information Regarding the Effects of Inflation *(Unaudited)*

CONSOLIDATED STATEMENT OF INCOME FROM CONTINUING OPERATIONS ADJUSTED FOR EFFECTS OF INFLATION
(in thousands of dollars)

For the year ended December 31, 1985	As Reported in the Primary Statement	Adjusted for Changes in Specific Prices
	(historical dollars)	(current cost)
Net sales	$1,996,154	$1,996,154
Cost of sales (excluding depreciation)	1,314,349	1,314,434
Selling, general and administrative expenses (excluding depreciation)	387,319	387,319
Depreciation expense	49,644	69,888
Interest expense, net	11,929	11,929
Income from continuing operations before income taxes	232,913	212,584
Income taxes	112,264	112,264
Income from continuing operations	$ 120,649	$ 100,320
Gain from decline of purchasing power of net amounts owed		$ 9,825
Increase in specific prices (current cost) of inventories and property, plant and equipment held during the year (see Note)		$ 49,859
Effect of increase in general price level of inventories and property, plant and equipment		44,475
Excess of increase in specific prices over increase in general price level		$ 5,384

Note: At December 31, 1985, current cost of inventory was $274.0 million and current cost of property, plant and equipment, net of accumulated depreciation was $976.9 million.

The Corporation's consolidated financial statements are prepared based upon historical costs and prices of transactions. The accompanying supplementary information reflects certain effects of inflation upon the Corporation's operations in accordance with the requirements of Statement Nos. 33 and 82 issued by the Financial Accounting Standards Board.

The effects of inflation on income have been measured using the "current cost" method. This method recomputes results of operations using the current cost of inventory and property, plant and equipment rather than the historical cost of such assets. Current costs were developed from external price indices, quotations or similar measurements. The impact of inflation on translated foreign operations is measured utilizing the Consumer Price Index for all Urban Consumers (CPI-U).

The current cost adjustment to cost of sales is not significant because substantial portions of inventories in the historical financial statements are stated at LIFO cost. Under LIFO, cost of sales in the historical financial statements approximates current costs.

The gain from decline of purchasing power of net amounts owed presents the Corporation's gain from holding more monetary liabilities (requiring fixed future cash settlements) than monetary assets (right to receive fixed amounts of future cash) during periods of inflation, thereby requiring less purchasing power to satisfy such future obligations. However, since this economic gain will not be realized until the obligations are repaid, it is excluded from inflation-adjusted net income.

FIVE-YEAR COMPARISON OF SELECTED FINANCIAL DATA ADJUSTED FOR EFFECTS OF INFLATION
(in thousands of average 1985 dollars except per share amounts)

For the years ended December 31,	1985	1984	1983	1982	1981
Net sales					
As reported	$1,996,154	1,848,492	1,662,663	1,565,736	1,451,151
At current cost	$1,996,154	1,914,446	1,795,275	1,745,002	1,716,450
Income from continuing operations					
As reported	$ 120,649	110,435	100,972	94,168	80,362
At current cost	$ 100,320	91,728	88,522	85,299	77,065
Income from continuing operations per share					
As reported	$ 3.85	3.52	3.22	3.00	2.81
At current cost	$ 3.20	2.93	2.82	2.72	2.69
Dividends paid per share of Common Stock					
As reported	$ 1.425	1.24	1.10	1.00	.875
At current cost	$ 1.425	1.28	1.19	1.11	1.03
Dividends paid per share of Class B Common Stock					
As reported	$ 1.285	.315	—	—	—
At current cost	$ 1.285	.33	—	—	—
Market price per share of Common Stock at year-end					
As reported	$ 51.50	38.63	31.63	28.25	18.00
At current cost	$ 50.68	39.45	33.57	31.06	20.60
Net assets at year-end					
As reported	$ 727,899	660,928	596,037	532,495	469,664
At current cost	$1,088,110	1,015,730	1,002,427	921,448	951,947
Gain from decline in purchasing power of net amounts owed	$ 9,825	9,455	13,413	11,808	25,491
Excess of increase in specific prices over increase in general price level	$ 5,384	(32,149)	33,986	(69,111)	(100,723)
Average Consumer Price Index					
Average CPI-U (1967 = 100)	322.2	311.1	298.4	289.1	272.4
Percent Increase	3.6%	4.3%	3.2%	6.1%	- 10.4%

Note: Reflects restatement of 1984 and 1983 for the divestiture of Cory Food Services, Inc. and Cory Canada Inc. Amounts for 1982 and 1981 have not been restated due to immateriality. Per share amounts have been adjusted for the two-for-one stock split effective September 15, 1983.

FIVE-YEAR COMPARISON

The five-year comparison above shows net sales, income from continuing operations, dividends per share and other information, computed using the "current cost" method. To provide comparative current cost data, the years 1981–1984 have been stated in dollar amounts expressed in terms of average 1985 dollars, as measured by the average CPI-U. The increase in specific prices compared with increases in general inflation has changed annually since costs for agricultural commodities often do not follow the trend of general inflation.

Management has taken various steps to minimize the impact of inflation on the Corporation's businesses. The use of LIFO inventory accounting for most inventories reduces reported earnings, thereby reducing income taxes and improving cash flow, in periods of inflation by matching current costs with current revenues. The capital expenditure program, through investment in modern plant and equipment, provides for future sales growth and manufacturing efficiencies. This and other programs designed to identify cost reductions and productivity improvements are a continuing part of the Corporation's approach to inflation management.

The Corporation also recognizes that the purchasing power of the dollar significantly affects its stockholders and has attempted to maintain or improve the inflation-adjusted dividend. In 1985, the Corporation provided real growth of approximately 11% in dividends per share of Common Stock.

Six-Year Consolidated Financial Summary

(all dollars and shares amounts in thousands except market price and per share statistics)

	1985	1984	1983	1982	1981	1980
Summary of Earnings[a]						
Net Sales	**$1,996,154**	1,848,492	1,662,663	1,565,736	1,451,151	1,335,289
Cost of Sales	**$1,355,789**	1,269,801	1,145,867	1,084,748	1,015,767	971,714
Selling, General and Administrative	**$ 395,523**	355,849	310,115	301,586	267,930	224,615
Interest Expense, net	**$ 11,929**	10,349	15,814	7,859	12,512	14,100
Income Taxes	**$ 112,264**	102,058	89,895	77,375	74,580	62,805
Income from Continuing Operations	**$ 120,649**	110,435	100,972	94,168	80,362	62,055
(Loss) from Discontinued Operations	**$ (8,422)**	(1,753)	(806)	—	—	—
Net Income	**$ 112,227**	108,682	100,166	94,168	80,362	62,055
Income Per Share from Continuing Operations	**$ 3.85**	3.52	3.22	3.00	2.81	2.19
Net Income Per Share	**$ 3.58**	3.47	3.20	3.00	2.81	2.19
Dividends Paid Per Share of Common Stock	**$ 1.425**	1.24	1.10	1.00	.875	.75
Dividends Paid Per Share of Class B Common Stock	**$ 1.285**	.315	—	—	—	—
Average Number of Shares of Common Stock and Class B Common Stock Outstanding During the Year	**31,337**	31,337	31,337	31,337	28,643	28,320
Income from Continuing Operations as a Percentage of Net Sales	**6.0%**	6.0%	6.1%	6.0%	5.5%	4.6%
Financial Statistics						
Capital Additions	**$ 114,449**	87,049	105,244	116,736	91,673	59,029
Depreciation[a]	**$ 49,644**	41,322	35,570	30,681	27,565	24,896
Advertising[a]	**$ 83,835**	78,570	68,374	64,046	56,516	42,684
Current Assets	**$ 412,290**	385,321	336,605	291,628	309,677	221,367
Current Liabilities	**$ 195,322**	202,953	151,634	148,893	134,035	111,660
Working Capital	**$ 216,968**	182,368	184,971	142,735	175,642	109,707
Current Ratio	**2.1:1**	1.9:1	2.2:1	2.0:1	2.3:1	2.0:1
Long-Term Debt	**$ 110,169**	125,236	127,990	140,250	158,182	158,758
Debt-to-Equity Percent	**15%**	19%	21%	26%	34%	44%
Stockholders' Equity	**$ 727,899**	660,928	596,037	532,495	469,664	361,550
Total Assets	**$1,197,432**	1,122,567	983,944	904,754	829,447	684,472
Return on Average Stockholders' Equity	**16.2%**	17.3%	17.8%	18.8%	19.3%	18.2%
After-Tax Return on Average Invested Capital	**12.7%**	13.5%	13.8%	14.3%	13.9%	12.8%
Stockholders' Data						
Outstanding Shares of Common Stock and Class B Common Stock at Year-End	**31,337**	31,337	31,337	31,337	31,337	28,320
Market Price of Common Stock At Year-End	**$ 51½**	38⅝	31⅝	28¼	18	11¾
Range During Year	**$ 55-35**	41¼–28¼	35–24⅜	29¾–16¼	20½–11½	13–10
Number of Common Stock and Class B Common Stock Holders At Year-End	**17,529**	16,729	16,467	16,033	16,817	17,774
Employee Data[a]						
Payrolls	**$ 391,781**	354,422	326,615	305,651	273,097	253,297
Full-Time Employees at Year-End	**15,240**	14,410	13,510	13,600	12,450	12,430

Notes:

(a) Amounts for 1984 and 1983 have been restated for discontinued operations. Amounts for 1982, 1981 and 1980 have not been restated to reflect discontinued operations due to immateriality.

(b) All shares and per share amounts have been adjusted for the two-for-one stock split effective September 15, 1983.

(c) Financial statistics include certain reclassifications which have been made to the December 31, 1982 and 1981 consolidated financial statements.

Directors and Senior Management

As of March 1, 1986

BOARD OF DIRECTORS

Richard A. Zimmerman
Chairman of the Board
and Chief Executive Officer

Richard T. Baker
Consultant, Ernst & Whinney
certified public accountants
Delray Beach, Fla.

Howard O. Beaver, Jr.
Retired Chairman of the Board
Carpenter Technology Corporation
Reading, Pa.

Edward R. Book
Chairman of the Board and
Chief Executive Officer
HERCO Inc.
Hershey, Pa.

John F. Burlingame
Retired Vice Chairman of the Board
and Executive Officer
General Electric Company
Stamford, Conn.

William E. C. Dearden
Retired Chairman of the Board
Hershey Foods Corporation

John C. Jamison
Dean, School of Business Administration
The College of William & Mary
Williamsburg, Va.

Dr. Ogden C. Johnson
Senior Vice President

Dr. Sybil C. Mobley
Dean, School of Business and Industry
Florida Agricultural and
Mechanical University
Tallahassee, Fla.

Francine I. Neff
Vice President and Director
NETS Inc.
privately-held investment company
Albuquerque, N.M.

H. Robert Sharbaugh
Retired Chairman
and Chief Executive Officer
Sun Company, Inc.
Hilton Head Island, S.C.

Kenneth L. Wolfe
President and Chief Operating Officer

AUDIT COMMITTEE

Richard T. Baker, *Chairman*
John F. Burlingame
Dr. Sybil C. Mobley
Francine I. Neff

COMPENSATION AND EXECUTIVE ORGANIZATION COMMITTEE

H. Robert Sharbaugh, *Chairman*
Howard O. Beaver, Jr.
John F. Burlingame
John C. Jamison

EMPLOYEE BENEFIT COMMITTEE

John C. Jamison, *Chairman*
Howard O. Beaver, Jr.
Edward R. Book
Dr. Sybil C. Mobley
H. Robert Sharbaugh

EXECUTIVE COMMITTEE

Richard A. Zimmerman, *Chairman*
Dr. Ogden C. Johnson
Kenneth L. Wolfe

NOMINATING COMMITTEE

Francine I. Neff, *Chairperson*
Richard T. Baker
William E. C. Dearden
Richard A. Zimmerman

DIVISION PRESIDENTS

John F. Cauley, Jr.
President
Friendly Ice Cream Corporation

David B. Conn
President
Hershey Canada Inc.

Richard M. Marcks
President
Hershey International Ltd.

C. Mickey Skinner
President
Hershey Pasta Group

Joseph P. Viviano
President
Hershey Chocolate Company

CORPORATE OFFICERS

Richard A. Zimmerman
Chairman of the Board and
Chief Executive Officer

Kenneth L. Wolfe
President and
Chief Operating Officer

Dr. Ogden C. Johnson
Senior Vice President

Kenneth L. Bowers
Vice President
Corporate Communications

Charles E. Duroni
Vice President and
General Counsel

William Lehr, Jr.
Vice President and
Secretary

William P. Noyes
Vice President
Human Resources

Michael F. Pasquale
Vice President, Finance and
Chief Financial Officer

William F. Suhring
Vice President
Corporate Development

Dr. Barry L. Zoumas
Vice President
Science and Technology

Thomas C. Fitzgerald
Treasurer

Howard W. Rush, Jr.
Controller and
Chief Accounting Officer

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Hershey Foods Corporation
Hershey, Pennsylvania 17033, U.S.A.